A BALANCING ACT: COST, COMPLIANCE, AND COMPETITIVENESS AFTER SARBANES-OXLEY

HEARING

BEFORE THE

SUBCOMMITTEE ON REGULATORY AFFAIRS

OF THE

COMMITTEE ON GOVERNMENT REFORM

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A BALANCING ACT: COST, COMPLIANCE, AND COMPETITIVENESS AFTER SARBANES-OXLEY

MONDAY, JUNE 19, 2006

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON REGULATORY AFFAIRS,
COMMITTEE ON GOVERNMENT REFORM,
New York, NY.

The subcommittee met, pursuant to notice, at 10 a.m., in the Auditorium of the U.S. Customs House, 1 Bowling Green, New York, NY, Hon. Patrick T. McHenry (chairman of the subcommittee) presiding.

Present: Representatives McHenry, Dent, and Maloney.

Also present: Representatives Kelly, and Feeney.

Mr. MCHENRY. Come to order. Good morning. I'm Congressman Patrick McHenry from North Carolina. I am chairing this subcommittee in Candice Miller's stead. She has been detained in Michigan due to a family health emergency. She's OK. She wanted me to communicate that, but unfortunately she cannot be here today.

I'm joined this morning by my colleagues from everywhere from New York to Florida. To my immediate right would be Mrs. Maloney, who actually represents Manhattan. And to my left, my good friend and fellow class representative, Charlie Dent from the 15th Congressional District of Pennsylvania, representing the Lehigh Valley. Next to him is Sue Kelly, representing just to the north of the city, Westchester and the Hudson Valley, representing New York's 19th Congressional District. And to her left is Tom Feeney from Florida, representing the space coast and Florida's 24th Congressional District. And we are looking forward to this hearing today on "A Balancing Act: Cost, Compliance and Competitiveness after Sarbanes-Oxley."

Both Tom Feeney, Mrs. Kelly and I are members of the House Financial Services Committee. I am also a member of the House Government Reform Committee. And under the auspices of the House Government Reform Committee, of which Charlie Dent and I both sit on, we're having this hearing today.

I am very pleased to be here in this historic setting discussing an important issue for our financial markets. New York has long been considered the financial capital of the world, although we in North Carolina are very pleased about our banking center in Charlotte and I'm pleased to represent a number of folks that work there. The reason why we're holding this hearing today is because of a growing concern that due to certain regulations and regulatory

matters and legislation that we've passed, America and New York is losing its lead as a financial capital to foreign exchanges.

To illustrate the point, I would draw your attention to a Wall Street Journal article of January 26, 2006 that reported: "In 2000, nine out of every ten dollars raised by foreign companies through new stock offerings were done in New York. By 2005, the reverse was true. Nine out of every ten dollars were raised through new company listings in London or Luxembourg."

Furthermore, on Tuesday, May 30, 2006, the Journal noted that the world's top 10 Initial Public Offerings since the passage of Sarbanes-Oxley, only 1 occurred on Wall Street.

Finally, it's not hard to conclude that the announced merger of the New York Stock Exchange with Euronext is due in part to their desire to recapture these lost listings. Indeed, the Wall Street Journal on Friday, June 2nd said this: that one factor pushing the New York Stock Exchange toward Euronext is the shriveling of initial public offerings by international companies amid a tougher U.S. regulatory environment.

Certainly, Sarbanes-Oxley was a reaction to World Com and Enron-style scandals. But this bill does offer some solid guidance to businesses. But unfortunately, the implementation, in particular of Section 404, a section just 168 words long, has resulted in some unintended consequences that have become a huge handicap for American businesses.

I've met with a number of business and banking leaders about this subject around the country and in North Carolina and they agree. Sarbanes-Oxley has made a dramatic and sometimes negative impact on the capital markets. Transparency is very important in corporate governance. We understand that as public policymakers. However, as a rule, less government regulation translates to more productivity, economic expansion and job growth. So we have to balance those competing interests and needs.

Congress did not intend to handicap U.S. businesses with these huge costs and the original SEC estimates said that annual compliance cost of the average firm would be somewhere around $91,000. Today, the average firm spends $3.7 million to comply with the requirements of Sarbanes-Oxley. The SEC underestimated the cost by a factor of 40 and that is after compliance costs have decreased. In fact, a moderate size community bank in my District spent $500,000 last year in direct costs associated with compliance of Sarbanes-Oxley, on top of all the other indirect costs they tally into many millions. And this is for a small community bank.

So we have to look at competitiveness around the world, if we're to draw that capital here to the United States and that's what this hearing is about today. I look forward to the distinguished panels that we have here today and my colleagues' questions as well.

And with that, I would now like to recognize my colleague, Mr. Dent, from Pennsylvania.

[The prepared statement of Hon. Patrick T. McHenry follows:]

A Balancing Act: Cost, Compliance, and Competitiveness after Sarbanes-Oxley

Opening Statement by Chairman Patrick McHenry

Committee on Government Reform
Subcommittee on Regulatory Affairs

Monday, June 19 2006, 10:00 a.m.
U.S. Customs House at 1 Bowling Green, New York, NY 10004

Good morning. The Subcommittee on Regulatory Affairs will come to order. I would like to welcome everyone to our hearing today entitled: "A Balancing Act: Cost, Compliance, and Competitiveness After Sarbanes Oxley."

I am very pleased to be here at the historic Alexander Hamilton Custom's House in Lower Manhattan and I have brought with me some of the most distinguished Members of the U.S. House of Representatives. Unfortunately, Chairman Candice Miller is unable to attend today's hearing due to family health concerns.

New York City has long been considered the Financial Capital of the World – although we in North Carolina are proud of our contributions to the financial services community as well. The reason why we are holding this hearing in Manhattan is because there is a growing concern that due to certain regulatory measures, America - New York - is losing its lead as the financial capital to foreign exchanges.

To illustrate this point, I would draw your attention to a *Wall Street Journal* article from January 26, 2006 that reported: "in 2000: nine out of every ten dollars raised by foreign companies through new stock offerings were done in New York....But by 2005, the reverse was true: Nine of every ten dollars were raised through new company listings in London or Luxembourg..."

Furthermore, on Tuesday, May 30, 2006, the *Journal* noted that of the world's top 10 Initial Public Offerings (IPO's) since the passage of Sarbanes-Oxley, only one occurred on Wall Street.

Finally, it is hard not to conclude that the recently announced merger of the New York Stock Exchange with Euronext is due in part to their desire to recapture these lost listings. Indeed, The Wall Street Journal on Friday, June 2nd said just this: that one factor pushing NYSE toward Euronext is the shriveling of initial public offerings by international companies amid a tougher U.S. regulatory environment.

Because of accounting scandals at companies like Enron or World Com- Congress passed the Sarbanes-Oxley Act that requires significant new disclosure and severe penalties for corporate officers that violate the law.

This bill does offer some solid guidance to businesses - but unfortunately, the implementation of Section 404- a section just 168 words long- has resulted in some unintended consequences that have become a huge handicap for American business.

I've met with many bank and business leaders in North Carolina as well as around the country - and they agree: Sarbanes-Oxley has made a dramatic, and sometimes negative, impact on the capital markets. Transparency in corporate governance is important. However, as a rule, less government regulation translates to more productivity, economic expansion and job growth.

Congress did not intend to handicap U.S. businesses with these huge costs. Original SEC estimates said the annual compliance cost for the average firm would be $91,000. Today- the average firm spends $3.7 million to comply with the requirements of Sarbanes Oxley. The SEC underestimated the cost by a factor of 40- and that is after compliance costs have decreased! In fact a regional community bank in my district spent $500,000 or more in direct costs to comply with the first round of auditing.

With this high cost, I am concerned that Sarbanes Oxley has become an unwitting accomplice to assisting our foreign competitors take away American jobs and take away listings from the American Exchanges. Some of these foreign exchanges actually advertise themselves as "Sarbanes Oxley Free Zones"!

At today's hearing, the Subcommittee is seeking to discover how investors use the 404 and 302 disclosures on internal control deficiencies when making stock purchases; we want to learn from our witnesses how Sarbanes Oxley has really affected the U.S. Stock markets in terms of liquidity, competitiveness, and overall health; we want to know what additional protection is provided by the costly Section 404, that Section 302 does not also provide; and we want to know what are the opportunity costs that investors and businesses alike must incur when companies spend between 1 and 4 million dollars to fully comply with Section 404.

This more precise understanding is critical to determine Section 404's full impact on U.S. businesses and the domestic stock markets and whether the current cost-benefit equation is net positive.

I look forward to hearing the testimony of all our witnesses today.

Mr. DENT. Thank you, Mr. Chairman. I'd also like to thank Chairman Miller for holding this critical hearing today on Sarbanes-Oxley Act and also thanks to Mr. McHenry for pinch hitting for her this morning. As a result of the accounting scandals of Enron and World Com, Congress passed the Sarbanes-Oxley Act of 2002 with the intent to restore public confidence in the financial market. SOX requires extensive disclosures about internal controls for public companies. Specifically, Section 302 requires corporate managers to attest to the accuracy and reliability of financial reports and disclose material witnesses in internal controls.

Section 404 requires that public companies must disclose their own financial controls as part of their annual report and requires an outside accounting firm to audit internal controls and the company's attestment before being considered compliant. While the intent may have been positive, regulatory demands of SOX compliance has become extremely expensive for companies to meet and become a major obstacle, perhaps prohibiting smaller businesses from going public.

I have had extensive discussions of this act with several constituents in my District. In fact, my good friend and constituent, Dave Lobach, is here today or will be here momentarily if he can park his car. Dave is the CEO of Embassy Bank in the Lehigh Valley. Dave and Elmer Gates, the chairman of Embassy, have given me a firsthand perspective as to the obstacles they face as a result of Sarbanes-Oxley.

Banking is a highly regulated industry in the United States and as community bankers, they are consistently inundated with various rules and regulations that go well beyond simple regulation and I believe it's safe to say well into the realm of debilitating. Currently, and this bank in particular, Embassy Bank is reviewed on an annual basis by the state and the FDIC. Furthermore, in addition to conducting its own internal audit process, Embassy also has a number of external auditors who consistently assess a variety of different criteria ensuring regulatory compliance on many levels.

I can say with certainty that many of the small businesses in my District see SOX as an anti-competitive initiative which adds additional process to an already over-regulated industry and adds tremendous cost in a business where the spreads are very thin.

I have concerns that when the financial markets become too duplicative and over-regulated, the cost will be passed on to or absorbed by the consumer. I was shocked when Mr. Lobach informed me that the costs—he informed me that the costs Embassy Bank will accrue this year to be SOX compliant will equal the cost of opening and operating another branch office for a single year.

I'm quite interested in this issue and the effects that the Sarbanes-Oxley Act has on the small businesses and banks in my District. I do not sit on this subcommittee or the Financial Services Committee, nor was I a Member of Congress when SOX was enacted in 2002. That said, I'm extremely interested in the testimony of these expert witnesses assembled here today and I'm eager to hear a bit about it, about their perspective as to the effects of Sarbanes-Oxley and the evaluation to cost and benefits of being SOX compliant.

Thank you, Mr. Chairman.

Mr. MCHENRY. At this point I recognize Congresswoman Kelly for the purposes of an opening statement.

Ms. KELLY. Thank you, Chairman McHenry, for holding this hearing.

I'd like to welcome Members of the subcommittee to New York and I really am very pleased to have the honor to have a constituent testify and to participate in a much needed discussion of the impacts of Sarbanes-Oxley Act on businesses in our country and in New York.

In 2002, I voted for the original Sarbanes-Oxley Act. At that time it was a much needed response to the scandals at Enron and World Com that had already hurt millions of small investors and threatened to destroy confidence in America's securities markets. As chairman of oversight and investigations, I held the first Enron and World Com hearings. Voting for Sarbanes-Oxley then was the right thing to do.

Four years later, America's economy is growing strong and consumer confidence is high. For all the success of this law, we do see some issues that demand attention. Employers in New York's Hudson Valley and around the Nation have experienced problems meeting the costs imposed by the regulators' interpretation of the law. We will hear the experiences of one of my constituents, David Lawrence of Warwick, NY, whose employer has brought numerous jobs to my District, but is struggling to meet the costs.

When Congress passed Sarbanes-Oxley, it never intended to force any company to choose between following the law and creating jobs. Sadly, bureaucratic regulation has chosen to interpret the law in ways that no longer seem to make sense. Although accounting costs for audits are declining, businesses with less than $100 million market cap are having to divert precious personnel and resources to comply with a law that was never intended to cover America's smaller or startup companies.

Smaller companies are increasingly raising capital outside the public markets and the IPOs have been delayed and many have moved off-shore. Given this situation, I think it's important that Congress examine how to ensure that our financial system remains strong, transparent and clean while allowing innovation and growth to flourish. Even the best laws need continued oversight in perfecting modifications.

Today's witnesses from academia and industry will allow us to explore the best way to comply with the spirit and the substance of Sarbanes-Oxley in a way that makes sense for this Nation.

I thank you for holding this hearing and I yield back.

Mr. MCHENRY. Thank you, Ms. Kelly. Mr. Feeney.

Mr. FEENEY. Thank you, Mr. Chairman. I'm especially grateful to you, to Chairman Davis and Chairman Miller for letting Congresswoman Kelly and I kibbutz on your subcommittee's hearings because it's something very important to me. I'll tell you that there are a couple of traditional truisms in Congress that Sarbanes-Oxley has, I think, proven in my view. One is that Congress has typically two speeds, zero and over-react and the second is that often the law of unintended, unforeseen consequences means that the adverse consequences of a well-intentioned bill are much greater than the positive consequences.

I have engaged for the last 9, 10 months in a listening tour, along with Congressman Meeks, Congressman Pete Sessions, Congressman Mark Kirk, and a few others at times and we have visited all three of the major exchanges in Chicago. We've been to the New York Stock Exchange, to the NASDAQ. I look forward to hearing Mr. Wolkoff's testimony which I've read. And I have come to a conclusion that it is time for a serious review of Sarbanes-Oxley. We now have enough empirical and anecdotal evidence across the board to know that the way it has been implemented, especially 404, has been counter productive.

Ultimately, the test is not how many headaches we create for members of the board of directors, for the CFO or the CEO, ultimately, the test is are we giving net added value to investors? And I believe the answer is in many cases an overwhelming no and as we now put small cap companies under the gun, the deadline has been extended I think until December 16th of this year, but I am concerned that we are going to have a massive adverse reaction to imposing these enormously complex requirements on small companies.

The bottom line is we have a conspiracy of two major problems that have come under the gun here. No. 1 is the way that Sarbanes-Oxley 404 has been implemented is very ambiguous in terms of what is a de minimis accounting error. There are lots of other standards that are not clearly set and you combine that with the fact that everybody involved, from the internal and the external auditors to the members of the board to the CFO, the CEO is under the gun for both civil and criminal liability. So over-zealous regulation is always the result when you have ambiguous rules and when you have essentially the death sentence for everybody involved.

You talked about the $35 billion estimated direct cost of compliance. I am much more concerned about the indirect cost of compliance with Sarbanes-Oxley. The estimates are as much as $1.1 trillion by two separate sources, which means that effectively this is an 8 or 9 percent regulatory tax on every transaction that occurs in the United States of America, and I believe that we are quickly outsourcing our lead in America's capital markets which we've had for about 100 years.

With that, Mr. Chairman, I'd like to just note that along with about 22 co-sponsors, I have filed a bill called the Compete Act. I would encourage people interested in Sarbanes-Oxley issues to take a look at that bill. We've got eight sponsors and co-sponsors led by Senator Jim Demint in the U.S. Senate and I'm just again really thrilled to be here.

Mr. MCHENRY. Thank you, Mr. Feeney. Because the Government Reform Committee has subpoena power, we always swear in our witnesses, so if you would all please rise with me, raise your right hands.

[Witnesses sworn.]

Mr. MCHENRY. Due to time restrictions, we'd ask you to please limit your opening remarks to 5 minutes. Your time will begin and be noted by the green light. They'll signify—when the yellow light flashes, it will signify you have 1 minute left. And I would ask you to please abide by that because we'd like to get to questions and

we'd like to have a full hearing and the interaction that we have with the questions between Members of Congress and the panel is really where we'll gain the most knowledge.

So with that, I'd like to recognize Mrs. Kelly for the purposes of introducing Mr. Factor.

Ms. KELLY. It gives me great pleasure to introduce Mr. Neal Wolkoff, who is chairman and chief executive officer of the American Stock Exchange and was appointed to the post in April 2005, after serving as an Acting CEO. Previously, he served as chief operating officer and several other senior level executive positions in the New York Mercantile Exchange, a member of the bar of the State of New York, and the U.S. District Court, Southern District of New York. Mr. Wolkoff received a B.A. from the College of Columbia University and a J.D. from Boston University School of Law.

Next is Mr. R. Cromwell Coulson. Mr. Coulson is the chairman and chief executive officer for Pink Sheets LLC. In 1997, he led a group of investors in acquiring Pink Sheets' predecessor, the National Quotation Bureau, reforming the company into the corporation which now exists. Prior to the acquisition of Pink Sheets, he was a trader specializing in distressed and value-oriented investments of over-the-counter market maker. He received a BBA from the Southern Methodist University in Dallas, TX.

Next, we have Mr. Mallory Factor. Mallory Factor is chairman of the Free Enterprise Fund and president and founder of Mallory Factor, Inc. He is also the chairman of the New York Public Asset Fund and Blue Cross Blue Shield Investment Advisory Board. He serves as a member of the Board of Governors of the New York State Banking Department. He is a member of the Council on Foreign Relations and served as vice chair of the Council on Foreign Relations Task Force on Terrorism Financing. He was appointed by President Ronald Reagan to the Federal Savings and Loan Advisory Council of the Federal Home Loan Bank. He's a graduate of Wesleyan University in Connecticut, attended Columbia University graduate business and law program.

We welcome you all and look forward to your testimony.

Mr. MCHENRY. And we'll begin with Mr. Wolkoff.

STATEMENTS OF NEAL WOLKOFF, CEO, THE AMERICAN STOCK EXCHANGE; R. CROMWELL COULSON, CEO, THE PINK SHEETS; AND MALLORY FACTOR, CHAIRMAN, FREE ENTERPRISE FUND

STATEMENT OF NEAL WOLKOFF

Mr. WOLKOFF. Thank you. Chairman McHenry and members of the subcommittee, on behalf of the American Stock Exchange, I would like to thank you for allowing me the opportunity to testify. As was stated before, I have submitted written testimony which I would like to become part of the official record.

I would like to briefly summarize the written testimony. The American Stock Exchange is the only national stock exchange whose business focus is on listing small and mid-cap companies. And therefore, we feel that the impact of Sarbanes-Oxley on listed companies, particularly those companies that are in the small-cap

arena are of particular concern to us, among the other national exchanges.

While some of our 600-listed companies are large cap, the vast majority has capitalization between $50 million and $1 billion and we find that any regulatory system that discourages these companies from participating in the public markets is of vital importance to our exchange and our listed companies.

Our experience in the 4-years since the law was enacted has been that regulators have yet to determine how best to address these corporate governance issues without disadvantaging smaller companies that lack the same resources as larger companies. Key problems that confront smaller companies involve Section 404 Sarbanes-Oxley, which requires designing, documenting and ordering of financial controls. Neither the PCAOB nor the accounting industry have adequately defined what it means or what is necessary to comply. This lack of clarity has increased costs so that the auditing firms leave no stone unturned no matter how remote or immaterial the issue may be.

The new regulations make no distinction between a $50 billion large-cap company and a $75 million small-cap company. The law's failures to recognize the differences makes it extremely difficult for smaller companies to compete and to grow in this current regulatory environment.

The lack of differentiation also places AMEX, as well as other U.S. exchanges, at a steep competitive disadvantage in listing foreign-based companies who instead choose to avoid U.S. capital markets. The lack of regulatory clarity allows foreign exchanges to arbitrarily fill in the blanks of Section 404 compliance as they cross the United States and market their own major benefit which is, of course, avoidance of Sarbanes-Oxley.

In a recent trip to Tel Aviv, which is a hot bed of entrepreneurship, particularly in health science and technology, I witnessed the London-based exchange AIM, aggressively marketing its lesser requirements and lower costs of governance contrasted with the United States. We're seeing firsthand some of the impacts of Sarbanes-Oxley on smaller companies and our experience to date raises serious concerns.

Last month, the exchange received a letter from one of our listed companies advising of its decision to delist its stock from trading on the AMEX. It went back to the Toronto Stock Exchange, citing the costs associated with Sarbanes-Oxley as the primary reason.

Another example of the impact of Sarbanes-Oxley occurred in conjunction with a marketing effort in which I participated several weeks ago in London. After expressing initial interest in listing on the AMEX, the chief executive of one of the target companies sent a message to me, explaining that the Sarbanes-Oxley requirements, as explained to him by his counsel, prevented any further consideration of the idea and he declined the invitation to attend dinner.

The SEC-appointed Advisory Committee on Smaller Public Companies has issued a report recommending that the SEC exempt some smaller and small-cap companies that comply with enhanced corporate governance provisions from Section 404 compliance. We support the conclusions of the advisory committee, believing that they represent a sound balancing of interest between regulation

and economic growth. However, shortly after our May conference of SOX implementation issues, the SEC and the PCAOB said that they did support exemption for smaller companies, though they indicated willingness to work with companies on implementation of the regulators.

This one size fits all approach is taken without regard to the impact of the cost and regulatory burden on the small, but important segment of the capital market place that smaller companies represent. In response to growing concerns of small business, Congressman Feeney introduced H.R. 5405, a bill that would modify Section 404, largely along the lines of the advisory committee recommendations.

We believe that something must be done. Even if the full range of the advisory committee's recommendations is not followed either by the SEC and the PCAOB or if a legislative solution is not enacted.

I'd be happy to answer questions, time permitting later on, as to a possible middle ground, because the American Stock Exchange is very interested in this issue.

Thank you.

[The prepared statement of Mr. Wolkoff follows:]

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Testimony of
Neal L. Wolkoff, Chairman and Chief Executive Officer
American Stock Exchange
before the
Subcommittee on Regulatory Affairs, House Committee on Government Reform
June 19, 2006

Madam Chairman and members of the Subcommittee, on behalf of the American Stock Exchange (Amex or the Exchange), I would like to express our appreciation for the opportunity to comment on issues related to the implementation of the Sarbanes Oxley Act of 2002.

Against the backdrop of highly publicized failures of major companies, Congress sought to address public concerns and restore investor confidence in capital markets through the passage of the Sarbanes-Oxley legislation. In the years since the legislation was originally enacted, implementation of the broadly based regulatory initiative has been met with both praise and criticism. In connection with the implementation of Section 404, the Securities and Exchange Commission (SEC or the Commission) established the Public Company Accounting Oversight Board ("PCAOB") and created the Advisory Committee on Smaller Public Companies. Similar to the experience with other aspects of the Sarbanes-Oxley legislation, recently released recommendations of the Advisory Committee on Smaller Public Companies were met with praise by some and with criticism from others. The Advisory Committee recommended exempting most small and mid-cap companies from the full requirements of Section 404. On one side are those who say that such an exemption would potentially leave 80 percent of public companies exempt from Section 404 requirements. On the other side, supporters of the Advisory Committee recommendations point out that the companies affected are relatively small – comprising only about 6 percent of total market capitalization, thus 94 percent of the equity market capitalization would be fully subject to Section 404 requirements.[1]

With so much at stake, we believe that it is worthwhile to examine the possibility of a compromise that aims to address concerns on both sides. Our testimony today includes an examination of alternative approaches to addressing the needs of policy makers, regulators, and small businesses.

[1] Final Report of the Advisory Committee on Smaller Public Companies to the Securities and Exchange Commission, April 23, 2006, page 7. http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf

<u>The Amex has substantial experience with smaller public companies</u>

As the only national stock exchange whose business focus is on listing small and mid-sized companies, we feel uniquely qualified to voice concerns on the effects of Sarbanes-Oxley (SOX) on this particular area of the capital market community.

While some of our 600 listed companies are large-cap companies, the majority has small and mid-capitalization between $50 million and $1 billion. Any regulatory system that discourages such companies from participating in the public markets is of vital importance to our Exchange and our listed companies.

Sarbanes-Oxley and the rules associated with it were established in 2002 to improve corporate governance and internal controls after a wave of accounting scandals that left a black eye on corporate America. These new regulations, however, made no distinction between a fifty billion-dollar large-cap company and a $75 million small-cap company. The law's failure to recognize the differences makes it extremely difficult for smaller companies to compete and grow in this current regulatory environment.

The lack of differentiation also places Amex and other U.S. exchanges at a steep competitive disadvantage in listing foreign based companies who instead chooses to avoid U.S. capital markets.

<u>Ownership and investor interest is different for small companies</u>

Investors need to be protected from the corporate scandals that became the impetus for Sarbanes-Oxley, but context is important. The large scandals that led to passage of Sarbanes-Oxley involved large companies or, like Enron, companies that pretended to be large companies. Large-scale investor concerns that were implicated in the Enron scandal typically are not pervasive in the case of small and micro-cap stocks, which, from looking at a sample of Amex-listed companies, frequently have substantial ownership in common between the entrepreneurs and their families who founded the company and public shareholders. The owners are not out to cheat themselves. The exchange's regulation of our listing requirements provides significant investor protection.

Regulators have yet to determine how best to address these corporate governance issues without disadvantaging smaller companies that lack the same resources as larger companies. Key problems that confront smaller companies involve Section 404 of Sarbanes Oxley, which requires designing, documenting and auditing of financial controls. ***Neither the PCAOB nor the accounting industry have adequately defined what it means-or what is necessary-to comply. This lack of clarity has increased costs so that the auditing firms "leave no stone unturned" no matter how remote or immaterial the issue may be.***

Complaints by smaller companies about inconsistency and lack of a uniform approach by accounting firms are supported by recent inspection reports posted on PCAOB's website.[2]. On June 8, a series of 14 inspection reports were added to the reports

[2] http://www.pcaobus.org/Inspections/Public_Reports/index.aspx

listed on the website, PCAOB found deficiencies in all 14 companies in over twenty five categories ranging from valuation of an intangible asset to revenue and testing for existence and completeness of a company's outstanding shares. The widespread problems with the accounting firms as reported by the PCAOB give support to those concerned over the lack of regulatory consistency and clarity.

This lack of regulatory clarity also allows foreign exchanges to arbitrarily "fill in the blanks" of Section 404 compliance as they cross the U.S. and market their own major benefit – avoidance of Sarbanes Oxley.

The SEC has taken steps to address these issues by creating an advisory committee to examine the impact of Sarbanes-Oxley and other aspects of the federal securities laws on smaller companies. In April, the Advisory Committee on Smaller Public Companies transmitted their recommendations, developed over the previous year with significant public input. As one of those invited to participate in one of several public hearings conducted by the Advisory Committee, the Exchange reached out to numerous Amex-listed companies - who represent the living concerns of this advisory committee - about their thoughts and recommendations on the "one size fits all" approach of SOX Section 404.

The Amex sought input from our market participants, and we received detailed and passionate feedback from the heads of listed companies that were not complaints about the SEC but thoughtful insights on how to implement securities regulations to accommodate the issues and challenges of smaller companies. The point that the chief executives of our listed companies wanted the SEC and the PCAOB to understand and acknowledge is that when it comes to regulating corporate governance, different standards need to apply to companies with small market capitalization or minimal revenues.

The most common concerns that our CEOs voiced on Section 404 related to: 1) duplicative or prohibitive costs, 2) the adverse impact on a company's relationship with its auditors, and 3) the requirement of segregation of duties within a small company.

Regarding costs to be compliant with Section 404, some of our companies told us that their auditing fees have tripled or quadrupled since the regulation was imposed. A $1 million auditing bill may be a drop in the bucket for a company with a $10 billion market capitalization, but for a $100 million dollar company that may have little or no revenue while awaiting FDA approval for a promising drug, or U.S. Patent Office approval for a new medical device, that is a significant amount of money.

<u>Smaller companies consider overseas exchanges – Loss of business and regulatory oversight</u>

Uncertainty over the extent to which Section 404 requirement will be applied has led to some smaller companies' consideration of utilizing non-U.S. capital markets. A May 8 article in <u>Forbes</u> magazine describes how concerns on Section 404 have led

smaller companies to look outside the U.S. for capital.[3] The article discusses recent decisions by smaller companies to eschew U.S. capital markets in favor of listing on foreign-based exchanges. In describing efforts by one exchange, the following passage is telling:

"Other foreign markets have made gains, too, but London's AIM has been particularly persistent. In recent months AIM executives have hosted more than 30 pitchfests (sic) in the U.S., wooing investors in New York, Boston, Silicon Valley, Atlanta, Denver and Minneapolis. "It's not particularly subtle," says Graham Dallas, a senior international development manager at the London Stock Exchange. "We tell them there is an opportunity-rich landscape for them to exploit. The rules are quite simple and short. Otherwise, companies will spend all their time on compliance and not enough time building wealth." (IBID)

The Financial Times in an opinion piece dated March 27, 2006 lauded London's mix of "measured regulation" and "pro-competition orientation" as the engine for the growth of London's role as a financial center. Sarbanes Oxley was labeled in this piece simply as one of "others' mistakes."

In a recent trip to Tel Aviv, which is a hot bed of entrepreneurship, particularly in health science and technology, I witnessed the AIM marketplace aggressively marketing its lesser requirements, and lower costs, of governance contrasted with the United States. However, in exploring in some depth the specific concerns that many of these companies have, I discovered that most take pride in their internal controls, and the integrity of financial reporting, so were not scared by the concepts. On the other hand, the lack of specific, clearly defined standards does frighten potential entrants to the U.S. markets, as does the annual cost of certification. I believe that some relatively small tweaking of rules, as well as clearly defined standards that provide guidance and safe harbors can go a long way to improving the problems with the statute's application and perception.

Recently, the Exchange has experienced firsthand the impact of Sarbanes Oxley on smaller companies seeking equity capital. Last month, the Exchange received a letter from one of our listed companies advising of its decision to delist its stock from trading on the Amex.

In a letter to the Exchange informing us of the company's decision, the executive explained the decision as related to the U.S. regulatory environment, and stressed that the company's stock will continue be traded on the Toronto Stock Exchange;

"In support of this request to voluntarily delist [company name redacted] shares from AMEX, we note that the shares of [company name redacted] of record are held by less than 300 persons worldwide and that the primary trading market for [company name redacted] shares is the Toronto Stock Exchange. We further note that the Board of Directors of [company name redacted] has determined that the costs and burdens of maintaining a listing on AMEX and of complying with U.S. securities regulatory requirements is not a cost effective

[3] "London Calling; Small companies skip the U.S., go public overseas," Forbes, Volume 177 Issue 10, May 8, 2006. http://www.forbes.com/forbes/2006/0508/051.html

application of the [company name redacted] financial and managerial resources as they outweigh the benefits to [company name redacted] and its shareholders."

Another example of the impact of Sarbanes Oxley occurred in conjunction with a European marketing effort in which I participated, the objective of which was to seek dual listing by European companies on the Amex. The following is the text from an email response to our invitation sent out in late May:

> "My interest in the AMEX was as a potential venue for a dual listing. I have just mentioned this possibility to our in house counsel and he went very red. It would appear that Sarbanes Oxley has completely put paid (sic)***["put an end to"]*** to any interest we may have had in such a scheme, so I am afraid to say that I feel there would be no point in my attending the dinner next week, and I will therefore be declining Mr Wolkoff's kind invitation." (Name withheld)

Obviously, U.S. exchanges that cater to smaller companies seeking capital by going public should be concerned by these recent events. However, those with a desire for a stronger regulatory approach should be concerned as well, for with the movement to non-U.S. exchanges, regulatory oversight is lost as well. The Amex believes in a having a strong regulatory environment, although one that allows competition to thrive. Further, the Amex believes that this position is consistent with the '34 Act.

PCAOB spurns the Advisory Committee recommendations – but is there a compromise position?

Following a joint SEC-PCAOB roundtable discussion held on May 10 to discuss implementation issues surrounding Section 404, the SEC and the PCAOB disappointed many small businesses by largely ignoring the recommendations of the Advisory Committee on Smaller Public Companies. [4,5] In public statements issued following the roundtable, both bodies said that though they would attempt to address implementation issues, that all companies would be expected to be in compliance with Section 404 requirements beginning with fiscal years starting on or after December 16, 2006.

Most industry experts agree that the legislation's intent is laudable, in that it punishes fraudulent behavior and demands executive accountability. However, regulators must take care to avoid the pitfall of imposing a uniform doctrine on small and mid-sized companies that are in the formative stages of their growth. Development stage companies with little or no revenue generally have less complicated financial statements (e.g., because they do not have revenue recognition issues) requiring less rigid internal controls.

The Advisory Committee on Smaller Public Companies report (op. cit.) recommended that the SEC give full Section 404 exemptive relief to some microcap and smallcap

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[4] No Sarbanes-Oxley break for small companies. Reuters, May 17, 2006 http://www.msnbc.msn.com/id/12839694/

[5] SECAnnounces Next Steps for Sarbanes Oxley Implementation. SEC Digest May 17, 2006, Issue 2006-95. http://www.sec.gov/news/digest/2006/dig051706.txt

companies that comply with enhanced corporate governance provisions. The proposed exemption would apply to:

- microcap companies--companies with equity capitalizations below approximately $128 million--that have less than $125 million in annual revenue; and
- small cap companies--companies with equity capitalizations between approximately $128 million and $787 million--that have less than $10 million in annual product revenue.

The committee also recommended that SEC should grant exemptive relief from external auditor involvement in the Section 404 process to smallcap companies with less than $250 million but more than $10 million in annual revenues, and microcap companies with between $125 and $250 million in annual revenues, subject to their compliance with the same corporate governance standards as the microcap firms.

The Advisory Committee report generated comments, both critical and supportive. Among other objections to the committee proposal for exemption from certain requirements of Sarbanes-Oxley Section 404 for smaller companies, was that 80 percent of public companies would be exempted in some way from compliance.[6] Supporters of the Committee's recommendations noted, however, that under the recommendations, 94 percent of the U.S. equity market capitalization would be fully covered by Section 404 requirements.

Is there a "middle ground?"

We support the conclusions of the Advisory Committee, and believe they represent a sound balancing of interests between regulation and economic growth. In its current form, Sarbanes Oxley reminds one of calls to increase the minimum wage to $15 an hour: laudable, ethical, but a recipe to move jobs to less laudable jurisdictions. One Israeli woman had it precisely right when she opined that "Sarbanes Oxley is **too** good!"

We also believe that something must be done even if the full range of the Advisory Committee's opinions are not followed, either by the SEC and the PCAOB, or if a legislative solution is not enacted. In an effort to obtain the bare bones of some relief, given the polarization of views about large-scale exemptions, I believe that compromise might benefit the process.

Recent statements by the SEC and the PCAOB cited earlier give little relief to smaller companies concerned with the significant burdens associated with full compliance with the provisions of Section 404. However, in response to growing concerns of small businesses, Congressman Tom Feeney introduced H.R. 5405[7], a bill that modifies Section 404 of Sarbanes Oxley by making compliance voluntary for companies in the following categories:

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[6] Letter from Damon Silvers, Associate General Counsel, AFL-CIO to Christopher Cox and William Gradison. Mar. 27, 2006, http://www.sec.gov/rules/other/265-23/aflcio032706.pdf

[7] http://thomas.loc.gov/cgi-bin/query/z?c109:H.R.5405:

- Total market capitalization for the relevant reporting period of less than $700 million
- Total product revenue for that reporting period of less than $125 million
- The issuer has fewer than 1,500 record beneficial holders
- The issuer has been subject to the requirements of sections 13(a) or 15 (d) of the Securities Exchange Act of 1934 for a period of less than twelve calendar months; or
- The issuer has not filed, and was not required to file, an annual report pursuant to section 13(a) or 15(d) of the Securities Exchange Act of 1934.

The legislation currently has 22 cosponsors, including the Chairman of this subcommittee. The Senate companion bill, S. 2824, introduced by Senator James DeMint has 8 co sponsors. The legislation represents some of the core recommendations of the SEC Advisory Committee on Smaller Public Companies (op. cit.) and is fully deserving of consideration.

Prior to the introduction of H.R. 5405, the Exchange offered suggestions on possible alternatives in a letter to the SEC and the PCAOB for consideration during their May 10 "roundtable" discussion of Section 404 issues[8]. We proposed that companies with $200 million in market capitalization and below should be allowed to choose non-compliance with Section 404, but that such a decision must be publicly disclosed, along with a statement as to why the company has chosen not to comply and whether (and if so to what extent) it has taken alternative voluntary steps to monitor its internal controls. Above that level, Section 404 compliance must be certified and then recertified every two to three years, not annually, based on capital. For example, compliance might need to be certified every two years for those companies with a market capitalization above $500 million but below $1 billion, and every three years for companies below $500 million, but above $200 million. Full compliance would be expected for those companies over $1 billion in capitalization. This approach gives flexibility to smaller companies, allows for investors to be informed, and provides for a path of growth that ultimately leads to full compliance with Section 404 requirements.

I believe that failure to distinguish the fundamental structural and financial differences between small companies seeking access to U.S. capital markets and larger well financed and capitalized companies in the application of Section 404 requirements would be a mistake that could be detrimental to small businesses in particular and to the U.S. economy in general. Further, the SEC and the PCAOB must be directed to apply clear, consistent guidelines and definitions to what it expects in Section 404 compliance. Not all business are run by CPAs or corporate attorneys. Applying Section 404 in a "one size fits all" manner without regard for the disproportionate cost and regulatory burden on smaller companies, as we have already witnessed in examples cited earlier, could well lead those companies to move to overseas capital

[8] Letter from Neal L. Wolkoff to SEC Chairman Christopher Cox and William Gradison, Acting Chairman of the PCAOB, May 8, 2006.

markets, resulting in both a loss of business for U.S capital markets, and, perhaps just as important, loss of any regulatory oversight that might otherwise be in place.

Global exchange mergers pose additional policy and regulatory questions
Mergers of exchanges, such as the recently proposed merger of the New York Stock Exchange (NYSE) and Euronext have the potential to pose additional problems for U.S capital markets, policy makers, and regulators. Already we are witnessing efforts by European, Asian, and other non-U.S. based exchanges to convince U.S. companies to eschew the U.S. capital marketplace in favor of foreign markets. Depending on the final structure of the NYSE-Euronext marketplace, the formerly domestic NYSE could well be in a position to benefit from companies' concerns over Sarbanes Oxley by accessing its European regulated arm, Euronext. In the absence of agreement amongst the respective regulatory bodies, multinational exchanges could attract U.S. companies seeking to avoid the expense and regulatory overhead of Sarbanes Oxley. Such a development would further complicate the current situation, and would doubtless work to the detriment of domestic capital markets without a non-U.S. subsidiary. Potentially, smaller companies would increasingly choose overseas capital markets for initial public offerings, and, arguably, it would be difficult to get them to return to the U.S. capital marketplace when they are of a size to be able to "afford" Sarbanes Oxley. Such a scenario would operate as a disincentive to US listing and SEC registration resulting in a significant regulatory gap.

We also believe that careful examination of the issues faced by smaller companies in complying with Section 404 as outlined in the recommendations of the Advisory Committee on Smaller Public Companies (op. cit.), could lead to a compromise that would not unduly burden small business, yet would provide investors with confidence. Recent actions and statements by the SEC and the PCAOB indicate inflexibility and, we believe, a failure to fully realize and appreciate the burdens placed on smaller companies by Section 404. The "one size fits all" approach is taken without regard to the impact of the cost and regulatory burden on the small but important segment of the capital marketplace that smaller companies represent. We have offered suggestions to an alternative approach the preserves the framework of Section 404, but allows for a more flexible approach to smaller companies. However, the urgency in clarifying the application of Section 404 is great. The legislative approach embodied in H.R. 5405, and Senate companion bill S. 2824 represents a realistic approach to the need to insure transparency and accountability without the stifling effect of a "one size fits all" approach to implementation of Sarbanes Oxley, and, if no other negotiated resolution is feasible, the legislative route should be pursued.

The flight of smaller companies seeking to avoid the expense of Sarbanes Oxley could ultimately be a "Marshall Plan" for overseas exchanges. Though unintended, the result of such a movement would certainly work to the detriment of U.S. capital markets, the U.S. economy, and to the oversight ability of U.S. regulators.

Thank you for the opportunity to provide our experience and input to this important issue. I will be happy to answer any questions that you may have.

Mr. FEENEY. Mr. Coulson.

STATEMENT OF R. CROMWELL COULSON

Mr. COULSON. I very much appreciate the opportunity to provide testimony to this subcommittee in connection with its investigation of the health, liquidity and competitiveness of U.S. equity markets during the implementation of the Sarbanes-Oxley Act.

Pink Sheets is the leading provider of pricing and financial information for the over-the-counter securities markets and, among other things, operates an electronic quotation and trade negotiation service for broker-dealers. While Pink Sheets is well known as the primary trading venue for the stocks of smaller public companies, the bulk of Pink Sheets trading by dollar volume takes place in distressed or reorganizing issuers and the securities of large international issuers.

My message today has four parts. First, we will share some of our thoughts about SOX, based on what we are hearing from smaller public companies; second, some statistics on deregistration; third, a few general observations about the competitiveness of U.S. markets; and fourth, we will describe our efforts to encourage cost-effective disclosure that protects investors.

We agree with everything about SOX, except for its costs. SOX has rightfully forced management to be responsible for their company's disclosure and accountants to stand behind their audits. Unfortunately, by removing the vendor-client tension from the audit process, accounting costs are no longer within the audit client's control. Regulators have given no guidance so the client can push back. We sincerely hope that the SEC's recent initiative to repair Section 404 audit process will rebalance the client-vendor relationship and rein in the cost burden for all issuers, large and small.

Approximately 500 issuers that have gone dark are currently trading in the Pink Sheets system. While the number of issuers going dark may seem high, from 2000 to 2005, over 5,000 issuers filed Form S–1s or SBTs to register securities in the public markets for the first time. Already this year over 500 issuers have filed with the SEC to be registered. So while there's been an increase in deregistration activity, it is simply not true that issuers have been exiting the registration system en masse.

It is true that many small issuers are still watching and if the costs become too burdensome, those numbers may change.

But this brings us to our third topic, the competitiveness of our equity capital markets for small companies. There's been much discussion lately suggesting that due to SOX 404, smaller U.S. companies are flocking to the LSE's alternative investment market. We don't really buy the argument that the success of the AIM is due to SOX 404. We see substantially more Canadian and Australian companies listing on the AIM than American companies and neither of those countries has adopted SOX or requires a Section 404 audit.

If you look at the Toronto Stock Exchange, who has a very successful tier for smaller issuers, most of their marketing materials now are saying why we're better than the AIM. And so that said, we think that much can be learned from other markets. In studying the AIM and other successful markets for small companies, we

are very impressed by the fact that capital raising is perceived as an integral part of the listing process. The London Stock Exchange publicized extensively the capital raised for its listed issuers to an extent that seems odd when compared to U.S. exchanges.

The AIM was designed to provide a successful opportunity for smaller U.K. companies to raise capital. That has created a community of advisors and capital providers for smaller U.K. companies. It is not surprising that by offering attractive capital-raising opportunities for smaller companies, the AIM is now finding a worldwide audience.

We have learned much from the AIM. I would respectfully suggest that the subcommittee's work would be enhanced by a thorough study of the AIM and what ideas can be brought to America.

Fourth, disclosure requirements must be effectively tailored for smaller companies. The challenge is to encourage disclosure that will protect investors from questionable issuers without giving—without driving good companies away. The AIM has an excellent solution. Smaller companies are required to appoint a professional gatekeeper which they call the NOMAD who works with the issuer and performs due diligence so that material information is disclosed to investors.

Our new OTCQX listing concept has been borrowed, in large measure, from the AIM process. Companies listing on the Pink Sheets OTCQX premium tiers, are required to appoint and pay for an attorney or broker dealer to review their disclosure. We believe that this review of an issuer's disclosure will benefit investors because much of the disclosure necessary to make good investment decisions is not contained in a company's GAAP financial statements or 404 controls.

Investment decisions for smaller issuers are usually based on the company's prospects. In contrast, the focus of a U.S. GAAP audit is on the disclosure of historical numbers. This has been lost in a lot of what the value of SOX brings. We all know historical performance is no guarantee of future results, as even truer of the smaller issuer working on a cure for cancer or some new technology that has no revenues. These plans and prospects must therefore be clearly described in the nonfinancial portions of an issuer's disclosure.

We think that the OTCQX disclosure review process will play such a valuable role for smaller issuers that we are agnostic of OTCQX issuers are SEC registered or just have audited GAAP finances. While we expect to attract companies that deregister with our more intelligent disclosure process, we believe that almost all of the OTCQX issuers who are interested in raising capital will still be registered with the SEC. That is because the most attractive U.S. capital pools for small issuers demand registration rights.

Even with registered issuers, we think the OTCQX review will serve the useful function of helping the issuer to get it right which should inspire greater investor confidence in OTCQX issuer disclosure. At Pink Sheets, we see great opportunities to create a vibrant and successful secondary market for small companies. A study commissioned by the AIM, states that a vibrant market for small to medium enterprises can add as much as 1 percent to the GDP

growth of a country's economy. We hope OTCQX becomes a part of that. Thank you.

[The prepared statement of Mr. Coulson follows:]

Written Statement by R. Cromwell Coulson
CEO, Pink Sheets, LLC

Before the Government Reform Subcommittee on Regulatory Affairs
Committee on Government Reform
House of Representatives
Congress of the United States

At the Hearing Entitled:
A Balancing Act: Cost, Compliance, and Competitiveness after Sarbanes-Oxley

US Customs House
New York, NY
June 19, 2006

I very much appreciate the opportunity to provide this written statement to the Government Reform Subcommittee on Regulatory Affairs in connection with its investigation of the health, liquidity and competitiveness of U.S. equity markets during the implementation of the Sarbanes-Oxley Act ("Sarbanes-Oxley").

Pink Sheets is the leading provider of pricing and financial information for the over-the-counter securities markets and, among other things, operates an Internet-based, electronic quotation and trade negotiation service for OTC equities for market makers and other broker-dealers registered under the Exchange Act. While Pink Sheets is well known as the primary trading venue for the stocks of smaller public companies, the bulk of Pink Sheets trading by dollar volume takes place in distressed or reorganizing issuers and the securities of large international issuers.

This written statement describes four of our observations about the impact of Sarbanes-Oxley. First, based on what we are hearing from issuers, we think Sarbanes-Oxley has negatively altered the relationship between issuers and auditing firms. Second, the statistics provide no support for the view that issuers are exiting the registration system in great numbers, as is sometimes claimed. Third, the evidence shows that U.S. markets and regulation continue to be competitive, although much can be learned from other market structures. Finally, we will describe our private initiatives to encourage cost-effective disclosure that protects investors.

The Effect of Sarbanes-Oxley on the Issuer/Auditor Relationship

I agree with everything about Sarbanes-Oxley, except for its costs. Sarbanes-Oxley has rightfully forced management to be responsible for their company's disclosure and accountants to stand behind their audits. Good internal controls are essential to the integrity of audited financial statements.

On the other hand, issuers report to us that the intrusion of auditors into the internal control process has left management without the ability to curtail unnecessary procedures. If the auditor insists that every paper clip must be counted to have effective controls, management is powerless to resist. By removing the vendor-client tension from the audit process, accounting costs are no longer within the audit client's control. This has the unfortunate result of providing an incentive on the part of the auditor to conduct unnecessary procedures with resulting runaway costs. I sincerely hope that the SEC's recent initiative to repair the Section 404 audit process by providing additional guidance will re-balance the client-auditor relationship and reign in the cost burden for all issuers, large and small.

Sarbanes-Oxley Has Not Caused a Mass Exodus from the Registration System

Before getting into the numbers, it is worthwhile to correct some common misconceptions.

The term "going dark" is commonly used to refer to companies that elect to deregister their securities under the Securities Exchange Act of 1934 (the "Exchange Act") because they have less than 300 holders of record. Where there continues to be public trading interest, the deregistered security generally is traded through facilities operated by Pink Sheets. The term should not be applied to issuers that "go private" because they are purchased by private investors. This distinction is not always made clear in the debate over Sarbanes-Oxley.

The term "going dark" is also somewhat misleading. Issuers of publicly traded securities have continuing public disclosure obligations, whether or not they have issued a class of securities registered under Section 12 of the Exchange Act. Federal securities laws require non-reporting issuers to make adequate current information about their business and securities publicly available under two important circumstances: First, when corporate insiders – officers, directors or large shareholders – are buying and selling securities in the public marketplace.[1] Second, when the issuer is encouraging the public to trade its stock by paying promoters to advertise its prospects.[2]

According to a recent Wharton study, 484 issuers elected to deregister, or "go dark," between 1998 and 2004.[3] The number of firms "going dark" reached a high of

[1] Rule 144(c)(2) under the Securities Act of 1933 (the "Securities Act") requires that adequate current information be made publicly available by non-reporting issuers when "control persons" are selling securities into the public markets. Rule 10b5-1 under the Exchange Act prohibits any person from purchasing or selling a security while in possession of material non-public information. Officer and directors of non-reporting companies generally will be in possession of material non-public information and cannot trade unless this information is made public.
[2] See SEC Petition for Rulemaking No. 4-519, submitted by R. Cromwell Coulson, "Request for Rulemaking under the Securities Act of 1933 to Expose and Prevent Unlawful and Deceptive Activities by Securities Promoters and Their Sponsors," (April 24, 2006).
[3] Leuz, Triantis and Wang, "Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations," March 13, 2006 (unpublished study), Table I. Attached as Exhibit A.

183 in 2003, falling off to 122 in 2004. We estimate that approximately 150 issuers elected to deregister during 2005 and another 35 during the first five months of this year, which means that approximately 700 issuers deregistered voluntarily during the period from 1998 to 2005.

Out of the 700 issuers that deregistered, approximately 500 issuers are currently trading in the Pink Sheets system. The remaining 200 issuers probably are no longer publicly traded. About 50 of the deregistered, but publicly traded, issuers, or 10%, provide disclosures to investors through the Pink Sheets News Service, an Internet site intended to encourage disclosure through private initiatives. The remaining 450, or 90% of these issuers, are truly dark – that is, providing little or no disclosures to investors. Of those truly dark we estimate that more than half would be classified as economically distressed so their exiting the disclosure system may be related to business distress rather than Sarbanes-Oxley. We also believe that managements of some truly dark issuers may be using the excuse of Sarbanes-Oxley to cut off the flow of information to shareholders to depress their stock price and buy out minority shareholders in a creeping takeover.

While the number of issuers going dark may seem high, from 2000 to 2005, approximately 5,500 issuers filed Form S1 or SB2 to register securities in the public markets for the first time. That was more than 10 times the number of issuers "going dark" during the period from 1998 to 2005. Already this year, 544 issuers have filed to be SEC registered. So, while there has been an increase in deregistration activity, it is simply not true that issuers are exiting the registration system en masse, as is sometimes claimed.

The Competitiveness of U.S. Capital Markets

This brings us to our third topic -- the impact of Sarbanes-Oxley on the competitiveness of our equity capital markets for small companies. There has been much discussion lately suggesting that, due to Sarbanes-Oxley, U.S. companies are flocking to Europe, and in the smaller public company space, to the AIM (Alternative Investment Market) tier operated by the London Stock Exchange. We don't really buy the argument that the success of AIM is related to Sarbanes-Oxley. We see substantially more Canadian and Australian companies listing on AIM than U.S. companies, and neither of those countries has adopted Sarbanes-Oxley or requires a Section 404 audit.[4]

That said, we think much can be learned from other markets. In studying the AIM and other successful markets for small companies, we were impressed by the fact that capital raising is perceived as an integral part of the listing process. The London Stock Exchange publicizes extensively the capital raised for its listed issuers to an extent that seems odd when compared to our brethren at the New York Stock Exchange or NASDAQ. Secondary market disclosure is part and parcel of the European capital raising process. AIM offers an intelligent listing process that is designed to provide

[5] Exhibit B contains a list of Canadian, Australian and U.S. Companies Listed on AIM.

smaller UK companies the opportunity to raise capital from the London investment community. It has successfully created a community of advisors and capital providers for smaller UK companies; it is not surprising that AIM is now finding a worldwide audience for the capital that an AIM listing can provide.

We think the reason capital raising is not perceived by U.S. markets as an integral part of the listing process is that federal securities laws tend to focus on disclosures made to purchasers of securities in public offerings, rather than the information needs of market participants. As far back as 1966, the late Milton Cohen persuasively argued that the emphasis should be the other way around.[5] That is, we would do a better job of protecting investors if we focused more on the information provided to market participants. After all, markets cannot operate efficiently without good information. And, capital raising cannot be effectively accomplished in the absence of efficient markets.

The production of information for the markets is largely a problem of incentives. Issuers that wish to raise capital view disclosure as a necessary means to that end and are only too happy to "open their kimono" if they believe that this will result in a nice pot of gold in the end from investors.

Issuers have much less reason to make disclosure to the markets if they have no current plans to raise capital. In the relatively difficult capital-raising market for smaller public companies that we have experienced in recent years, smaller issuers have tended to view disclosure as an expensive nuisance, an impression heightened by the increased costs imposed by Sarbanes-Oxley. This is particularly true if management's performance has been something less than brilliant; shareholders are known to get prickly when they receive a disappointing report about their investment.

We think the active participation of markets, such as AIM, in the capital raising process encourages better disclosure to investors. The best public service that can be provided by regulation, in our view, is to supply the additional incentives necessary to induce useful disclosure when market forces are insufficient to stimulate this socially beneficial behavior. When markets are involved in the capital raising process, issuers have much more incentive to continue providing disclosure to market participants. This is particularly true in the market for smaller public companies, where capital raising activities in the public markets have historically experienced abundance in some years followed by several lean years.

[5] In 1966, in an influential article, Milton Cohen proposed that the disclosure standards of the Exchange Act should be equivalent to those under the Securities Act: "[T]he combined disclosure requirement of these statutes would have been quite different if the 1933 and 1934 Acts (the latter as extended in 1964) had been enacted in opposite order, or had been enacted as a single, integrated statute--that is, if the starting point had been a statutory scheme of continuous disclosures covering issuers of actively traded securities and the question of special disclosures in connection with public offerings had been faced in this setting. Accordingly, it is my plea that there now be created a new coordinated disclosure system having as its basis the continuous disclosure system of the 1934 Act and treating "1933 Act" disclosure needs on this foundation." Cohen, "Truth in Securities Revisited," 79 *Harv. L. Rev.* 1340, 1341-1342, as quoted by Loss and Seligman, *Securities Regulations* § 2-D-1, *n. 2.*

We have learned much from AIM; I would respectfully suggest that the Subcommittee's work would be enhanced by a thorough study of AIM to see what can usefully be done here to improve our markets and the capital-raising process.

Pink Sheets Initiatives to Encourage Better Disclosure by Issuers

There can be no doubt that securities markets best perform their function of setting fair and accurate prices where buyers and sellers have full and complete access to all material information.[6] Nevertheless, as a practical matter, information cannot be made available without cost, and good information may be quite costly to produce. Sarbanes-Oxley has increased the cost of providing information for reporting companies, and this increased cost has resulted in more issuers going dark.[7] As a result, requiring all issuers of publicly traded securities to be registered and fully reporting is probably impractical.

The fact is that registration is not an end in itself, but a means to an end. The purpose of registration is disclosure. Registration and SEC filings provide a mechanism to make sure that investors are receiving the information they need to make sensible investment decisions.

Registration is not the only way that investors receive information. Bankrupt issuers cannot satisfy the registration requirements of the Exchange Act because their financial statements cannot be audited without qualification. But, issuers in reorganization produce reams of publicly available information about their finances and operations, most of which is available through the Internet. At Pink Sheets, we have been encouraging non-reporting issuers to provide information to investors through postings in the Pink Sheets News Service. We submit that it shouldn't matter to investors whether they obtain the information through a government website, such as the SEC's EDGAR site for reporting issuers, or the Internet sites made available by the bankruptcy courts, or through a privately-operated site, such as the Pink Sheets News Service. It is the quality of information, and the ability of investors to access that information freely, that counts, not the Internet site of its production.

This suggests that a more nuanced approach to market disclosure may result in better disclosure, and more efficient markets, than the current regime.

Two years ago, we launched the Pink Sheets News Service, an Internet repository where issuers can post information about their business and securities. This information is freely available to investors and regulators. We have encouraged issuers

[6] As noted by a House Committee in 1934: "No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 5, 11-12 (1934), as quoted by Loss, *supra*, § 6-A.
[7] See C. Coolidge, "Who Needs the Aggravation?" *Forbes*, October 14, 2002.

to follow the requirements for providing adequate current information found in Rule 144 under the Securities Act. Borrowing heavily from guidance published by the SEC, we published disclosure guidelines to encourage more complete disclosure.[8] This has all been done by private initiative – Pink Sheets is not a regulator. However, we do have the right to penalize issuers that fail to make good disclosure and have blocked quotes for the securities of issuers who failed to measure up to federal standards.[9]

Recently, we have taken things a step further by creating the OTCQX premium tiers.[10] Designed to clearly differentiate operating companies with audited financials that can meet certain minimum requirements, the OTCQX premium tiers provide issuers with a mechanism to publish quarterly and annual audited financial reports, management certifications, and interim event disclosure. The centralization of issuer-certified disclosure, together with listing standards for inclusion in the tiers, should substantially improve the OTC market, promote continued disclosure in the absence of SEC reporting, and highlight the best issuers in the OTC market to the investment community.

Pink Sheets lacks the resources to perform due diligence to confirm the reasonableness of issuer disclosure. Nonetheless, there is a need for some independent review because investors lack confidence in disclosures made by issuers without independent review. This is particularly true in the market for smaller public companies because the entrepreneurial spirit of this cohort often means that issuers are playing closer to the edge than their larger counterparts. The challenge is to encourage disclosure that will protect investors from questionable issuers and provide some form of independent review, without demanding so much costly disclosure that good companies will be driven out of business.

We were impressed by the solution conceived by AIM. Smaller companies are required to appoint a professional gatekeeper, which they call the nominating advisor or NOMAD, who works with the issuer and performs due diligence so that material information is disclosed to investors. Our OTCQX listing concept has been borrowed in large measure from the successful NOMAD used by AIM.

Companies listing in the Pink Sheets OTCQX premium tiers are required to appoint and pay for an attorney or broker-dealer to review its disclosures.[11] We call these appointed professionals "DADs," which stands for "Designated Advisor for Disclosure." We expect that DADs will review the non-financial portions of an issuer's disclosure to determine whether there is a reasonable basis to believe the statements of the issuer regarding its business and competitive environment. As always, it is hoped that the attorney or broker-dealer, who will work for a fee and perhaps the hope of more business, will not be willing to risk loss of reputation and business viability to assist an

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[8] The Pink Sheets Guidelines for Providing Adequate Current Information are attached as Exhibit C.
[9] This is based on our freedom to determine who we will deal with and on what terms – the freedom of contract right enjoyed by every private citizen.
[10] A Brochure describing the OTCQX Premium Tiers is attached as Exhibit D.
[11] The OTCQX Rules are attached as Exhibit E.

issuer in the commission of a fraud or even questionable disclosure. The DAD will not be required to confirm the financials, which will still be audited.

We believe that a DAD or NOMAD may protect investors in small issuers more effectively than a Section 404 audit because much of the disclosure necessary to make good investment decisions is not contained in a company's GAAP financial statements. Investment decisions for smaller issuers are usually based on investor evaluation of the company's prospects. In contrast, financial disclosure prepared in accordance with US GAAP is historical, reflecting prior periods. It is a truism that "historical performance is no guarantee of future results," and this is clearly true of the smaller issuer working on a cure for cancer or some new technology that has no revenues. A company's plans and prospects must therefore be described in the non-financial and necessarily unaudited portions of an issuer's disclosure, and these disclosure elements bear heavily on the investment decision. The DAD can be useful in determining whether the smaller issuer's disclosure of its prospects has a reasonable basis in reality.

We think that the DAD will play such a valuable role for smaller issuers that we are agnostic if OTCQX issuers are SEC registered or just have audited U.S GAAP financials. In either case, an issuer listed in OTCQX will be required to appoint a DAD. But, we expect that almost all of the OTCQX issuers who are interested in raising capital will have a class of securities registered under the Exchange Act. Even with registered issuers, we think the DAD will serve the useful function of helping the issuer to "get it right," which should inspire greater investor confidence in OTCQX issuer disclosure.

Conclusion

We think that investors would be better protected if secondary markets were more involved in the capital raising process. Continuing market disclosure would then be viewed as paramount, as compared to disclosure provided to initial investors in public offerings. At the same time, considering the needs of market participants in connection with capital raising results in a more nuanced approach that considers, not only the benefits of disclosure, but also the costs of its production. We believe the result would be more efficient secondary markets and enhanced opportunities for capital-raising.

The great promise of the Exchange Act is to ensure the maintenance of fair and honest securities markets.[12] Adequate and regular public disclosure is the method most often employed under this legislation to achieve this great and lofty purpose. We hope this hearing is part of a dialog that will inspire a more sophisticated approach to market disclosure and investor protection in the securities of smaller public companies.

At Pink Sheets we see great opportunities to create a vibrant and successful secondary market for small companies. A study commissioned by the AIM stated that a vibrant market for Small to Medium Enterprises can add as much as 1% to the GDP of a

[12] See Exchange Act, Section 2.

country's economy.[13] We hope OTCQX becomes a vibrant market that contributes to this worthy goal.

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[13] Oxford Analytica, "Assessment of the Economic Benefits and Opportunities for a Pan-European Growth Market," (October2005). Attached as Exhibit E.

Mr. MCHENRY. Thank you, Mr. Coulson.
Mr. Factor.

STATEMENT OF MALLORY FACTOR

Mr. FACTOR. Chairman McHenry, distinguished members of the subcommittee, I'm honored to testify here today about my views on Sarbanes-Oxley legislation. My remarks are based on the work that I've undertaken as chairman of the Free Enterprise Fund and Free Enterprise Institute.

Recently, you may know the Free Enterprise Institute has joined with a small Nevada accounting firm to launch a legal challenge to the constitutionality of the Public Company Accounting Oversight Board [PCAOB].

Today, I'll focus on the economic concerns about Sarbanes-Oxley in four main areas: its cost to our public companies, its discouragement of American entrepreneurship, its disproportionate burdens on small businesses, and finally, its adverse effects on the global competitiveness of our capital markets.

In my written testimony I also discuss the unintended beneficiaries of Sarbanes-Oxley and the unconstitutional Public Company Accounting Oversight Board. I welcome the opportunity to discuss any of these issues in response to your questions.

First, Sarbanes-Oxley has imposed enormous costs both direct and indirect on our public companies. The passage of Sarbanes-Oxley coincided with the loss of $1.4 trillion of shareholders' wealth. No more than $400 billion of that loss could be explained by other factors. In other words, Sarbanes-Oxley had a $1 trillion negative impact on the U.S. economy, a $1 trillion decrease in shareholder value is just the opposite of the growth to increased investor confidence that supporters of the legislation predicted would result in the passage of Sarbanes-Oxley.

Estimates from the American Electronics Association showed that U.S. companies are spending an aggregate of $35 billion a year just on Section 404 compliance, almost 3,000 percent more than the SEC's projected cost of $1.2 billion in June 2003.

The cost of being a public company in the United States has increased dramatically. The average cost of being a U.S. public company has increased by $1.8 million, a stunning 174 percent increase. This cannot be what Congress intended. These costs must be reduced for the sake of America's economic health.

Second, Sarbanes-Oxley is discouraging entrepreneurship. Inaccessible public capital markets have ripple effects that touch even the earliest stage investments. With fewer liquidity events on the horizon for most startups, fewer early stage investments are economical. Many of the startups that do get funded will have difficulty raising enough capital to succeed as they begin to grow out of their development phase. The capital that is available, often takes the form of expensive equity, private equity of mezzanine financing.

In addition, the criminal provisions put a further chill on entrepreneurship. CEOs and CFOs are required to certify corporate reports without traditional good-faith protections. They can also be held criminally liable for honest mistakes in those reports.

The Nobel Prize winning economist, Milton Friedman said, "it's costing the country a great deal. Sarbanes-Oxley says to every entrepreneur for God's sakes don't innovate, don't take chances because down will come the hatchet. We're going to knock your head off."

Third, Sarbanes-Oxley has a disproportionate negative effect on small business. Compliance costs are not coming down. Last week a study showed audit fees for small cap companies jumped over 20 percent in 2005 alone. From 2003 to 2005, audit fees have increased a startling 141 percent for small-cap companies. This increase is significantly higher than the still costly increase of 104 percent for medium size companies and 62 percent for large capitalization companies over the same period.

For companies with less than $1 billion in yearly revenues, average Sarbanes-Oxley compliance costs have increased 174 percent overall since inception. I believe that relief for small and medium-sized companies is the most urgent aspect of reform which Congress should address immediately.

Fourth and finally, Sarbanes-Oxley hinders America's standing in the global economy. Last year, the London Stock Exchange had a record year for foreign listings. In a survey of these new listings, they discovered that 90 percent of the companies that considered listing in the United States said London's Exchange was more attractive because the companies listing there did not have to comply with Sarbanes-Oxley.

In 2005, 23 of 24 companies that raised over $1 billion in capital chose not to register on U.S. exchanges, according to the New York Stock Exchange. In 2000, prior to Sarbanes-Oxley, 9 out of 10 of the largest IPOs in the world involved the U.S. public markets. In sharp contrast, last year 9 out of 10 of the top IPOs avoided the U.S. markets all together.

If Sarbanes-Oxley is good for investors, they should be willing to be paid for the benefits, but a study by Professor Kate Latvic of the University of Texas School of Law shows that investors, in fact, do not prefer such regulated companies. Her study found that investors preferred companies not subject to Sarbanes-Oxley.

In conclusion, I believe that the common interest of businesses, investors and all Americans require a thoughtful revision of Sarbanes-Oxley. Such reform to reduce the counter-productive and unintended ill-effects of Sarbanes-Oxley will enable our entrepreneurs, our investors and our workers to have confidence that America will continue to lead the world in competitiveness, productivity and economic abundance.

I look forward to your questions and I also wish quick recovery for Chairman Miller's husband and I thank her for putting this together.

[The prepared statement of Ms. Factor follows:]

FREE ENTERPRISE FUND

INVEST IN ECONOMIC FREEDOM

Written Testimony of Mallory Factor
Chairman
Free Enterprise Fund
before the Committee of Government Reform
Subcommittee on Regulatory Affairs
United States House of Representative

June 19, 2006

Chairman Miller, Ranking Member Lynch, and Distinguished Members of the Regulatory Affairs Subcommittee, thank you for inviting me to testify today about my views on the critical issue of the costs and effects of the Sarbanes-Oxley Act. I would also like to thank all of you who have been working so hard to address this issue, including Reps. Patrick McHenry, Carolyn Maloney, Charles Dent, and the other members of the Government Reform Committee. I especially appreciate the attention to this issue from Reps. Sue Kelly and Tom Feeney, here today from the Financial Services Committee.

My testimony will focus on six main areas: first, the costs, both direct and indirect, that Sarbanes-Oxley has imposed on our public companies; second, the discouragement of entrepreneurship caused by Sarbanes-Oxley; third, the disproportionate affect the law has had on small businesses; fourth, Sarbanes-Oxley's negative effect on America's global competitiveness; fifth, the unintended beneficiaries of the Sarbanes-Oxley legislation; and finally, the unconstitutional board created by Sarbanes-Oxley.

My remarks are based on the extensive work that the Free Enterprise Fund and the Free Enterprise Institute, two organizations of which I am chairman, have undertaken in the past year. In addition to this work, the Institute has joined with a small Nevada accounting firm to launch a legal challenge to the constitutionality of the Public Company Accounting Oversight Board (PCAOB).

Sarbanes-Oxley has significantly increased the costs of being a public company by requiring that they comply with burdensome and overbearing regulations. The law has also forced companies that would otherwise have raised capital efficiently and economically in our public markets to opt for more-expensive private financing or to list on overseas exchanges, such as the London Stock Exchange. Whatever perceived benefits Sarbanes-Oxley provides, they come at an unaffordable price.

Sarbanes-Oxley's Costs Outweigh its Perceived Benefits

Given the statistical research, survey data, and hard empirical evidence available to us in the past few years' experience, the costs, in fact, grossly outweigh the perceived benefits.

According to an event-analysis conducted by Ivy Xiying Zhang, now a professor at the University of Minnesota, the key legislative events leading to the passage of Sarbanes-Oxley coincided with the loss of $1.4 trillion of shareholder wealth. Dr. Zhang found that no more than $400 billion could be explained by other factors; in other words, Sarbanes-Oxley had a trillion-dollar negative impact on the US economy. A one trillion-dollar loss in shareholder value--quite the opposite of the alleged restoration of investor confidence touted by the law's supporters.

The costs of being a public company have increased dramatically. The most recent survey conducted by international law firm Foley & Lardner found that since the passage of the law, the average costs of being a public company have increased by $1.8 million--a startling 174 percent increase, with the highest relative burden falling upon small business. Foley & Lardner also found that 20 percent of public companies are considering going private to avoid Sarbanes-Oxley compliance.

Compliance costs for section 404, alone, are expected to average $4.36 million per company, up 39 percent from the $3.14 million they expected to pay, according to a 2004 survey by Financial Executives International.

Estimates from the American Electronics Association show that US companies are spending an aggregate of $35 billion on section 404 compliance, far greater than SEC's projections of just $1.2 billion in June 2003.

Audit fees of *Fortune* 1000 companies, on average, increased over 100 percent from 2003 to 2004, according to a paper by professors at the University of Nebraska at Omaha.

Until the law is reformed, companies will continue to move offshore, de-list from U.S. exchanges, and go private to avoid burdensome compliance. All of these are perfectly legal strategies, of course, but they hurt the very same investors that Sarbanes-Oxley intended to protect. Moreover, companies that otherwise would have gone public in the United States and had affordable, efficient access to our capital markets are now forced to access the more expensive private or overseas capital markets.

These enormous costs cannot be what Congress intended when Sarbanes-Oxley was enacted. They must be reduced or eliminated for America to continue to grow and prosper.

Sarbanes-Oxley Discourages Entrepreneurship

It is not just established businesses that are deleteriously affected by Sarbanes-Oxley. Inaccessible public capital markets have ripple effects that touch even the earliest stage investments. With fewer liquidity events on the horizon for most start-ups, fewer early-stage investments are economical. Many of the start-ups that do get funded will have difficulty raising enough capital to succeed as they begin to grow out of their development phase. The capital that is available often takes the form of expensive private equity or mezzanine financing.

In addition, the criminal provisions in the law expand the ability of the government to wield a terrifying regulatory tool and put a further chill on entrepreneurship. Under Sarbanes-Oxley, it is now possible for CEOs and CFOs to be sent to jail for the misdeeds of others. These executives are required to certify corporate reports without traditional good-faith protections, and can be found criminally liable for honest mistakes. Uncertainty on the limits the government will put on criminal prosecution under Sarbanes-Oxley has a chilling effect on risk-taking and has sizeable opportunity costs for the U.S. economy.

Of course, nothing should get in the way of the prosecution of corrupt executives. The recent Enron trials, based on statutes that had nothing to do with Sarbanes-Oxley, show that the legal system can be effective at punishing true scoundrels. Indeed there have been more than 700 corporate crime convictions and over $250 million in restitution since 2002, all prosecuted under pre-Sarbanes-Oxley laws.

The problem with Sarbanes-Oxley is that it treats the innocent as if they were guilty—swamping everyone with a huge new cost. And most perversely of all, the costly form-filling-out required by Sarbanes-Oxley does nothing to encourage truly honest and ethical behavior. The law is mostly a series of expensive hurdles for public companies—plus a few landmines.

The Nobel Prize-winning economist Milton Friedman called Sarbanes-Oxley the biggest problem facing the U.S. economy. He said: "It's costing the country a great deal. Sarbanes-Oxley says to every entrepreneur, 'For God's sake don't innovate. Don't take chances because down will come the hatchet. We're going to knock your head off.'"

Corporate crime is serious and should be prosecuted to the fullest extent of the law. But it is important to remember that the previously existing criminal laws are being used to actually convict corporate criminals in corporate wrongdoing trials, not Sarbanes-Oxley.

Sarbanes-Oxley Disproportionately Harms Small and Medium Sized Businesses

The SEC Advisory Committee on Smaller Public Firms, the United States Small Business Administration (SBA), and countless other public and private observers have stated that Sarbanes-Oxley disproportionately affects small businesses seeking access to capital.

Michael See, of the SBA, testified before this very committee on May 3rd and spoke about the significant value of the small business sector to the US economy. He noted that small businesses create 60 to 80 percent of net new jobs in this country and file more than 13 times as many innovative patents per employee than large companies. But the fixed costs of compliance with regulations hit these innovative companies the hardest.

Last week, Foley & Lardner released their fourth annual national Sarbanes-Oxley study. The study found that there is little truth to the widely heard claims that Sarbanes-Oxley compliance costs are coming down. Rather, it showed that audit fees for small-cap companies jumped over 20 percent in 2005. From 2003 to 2005, audit fees increased a startling 141 percent for these small-cap companies, significantly higher than the still costly increases of 104 and 62 percent for medium and large capitalization companies, respectively, over that period.

For companies with less than $1 billion in yearly revenue, average Sarbanes-Oxley compliance costs have increased 174 percent overall since its inception. This law is not economical for even the largest companies, but it effectively dictates that smaller companies cannot afford to be publicly traded in the US financial markets.

The SEC's own Advisory Committee on Smaller Public Companies strongly recommended that smaller firms be exempt from the most burdensome requirements of Sarbanes-Oxley. I believe that exemptive relief for small- and medium-sized companies is the most urgent aspect of reform which Congress could address.

Sarbanes-Oxley Weakens Our Ability to Compete Globally

Companies are increasingly looking overseas where the regulatory burdens required to list in public markets are significantly lower. Recent statistics show that America's traditional leadership in financial services is at risk.

A clear trend has already emerged with respect to foreign companies, which used to list in New York regularly but are now listing elsewhere. Foreign companies do not want to be subject to the costly and onerous burdens of Sarbanes-Oxley. Thus, international companies, in many sectors of vital strategic interests such as electronics and biotechnology, are accessing the European capital markets instead of our own. For many investors who confine themselves to U.S. markets, these are lost investment opportunities. For the financial services companies here in New York as well as in other parts of our county, this is lost business—and lost jobs, less tax revenue, and a decreased international presence.

In 2000, prior to the enactment of Sarbanes-Oxley, nine of the 10 largest IPOs in the world involved the U.S. public markets. In contrast, last year nine of the 10 largest IPOs avoided the U.S. markets altogether.

Last year, the London Stock Exchange had a record year for foreign listings. In a survey of these new listings, they discovered that 90 percent of companies that considered listing in the U.S. said Sarbanes-Oxley made London more attractive. The London Stock Exchange is actually using their Sarbanes-Oxley-free status in their marketing material to attract new company listings.

In 2005, 23 of 24 firms that raised over $1 billion in capital didn't register in U.S. markets, according to the New York Stock Exchange. 129 companies listed with the London Stock Exchange last year—only six listed on the NYSE and 14 on Nasdaq.

It's axiomatic that if America loses its advantage in capital formation, then our advantage in every other index of business well-being will be put at risk, too, as the higher cost of capital caused by Sarbanes-Oxley starts to damage the rest of the US economy, including, inevitably, jobs and wages.

But do investors favor companies that are regulated by Sarbanes-Oxley? A study by Professor Kate Litvak of the University Of Texas School Of Law shows that investors, in fact, do not prefer such regulated companies. Professor Litvak compared foreign companies listed on US exchanges (and thus Sarbanes-Oxley compliant) with analogous foreign companies that were listed in foreign exchanges. These pairs of companies were matched in market capitalization, revenues, and other relevant financials, and differed only with respect to their listing and, therefore, Sarbanes-Oxley-status. She found that investors believed Sarbanes-Oxley has a net-negative effect on companies forced to comply.

This is an important point, worth pausing over: According to Professor Litvak, investors considered the costs of Sarbanes-Oxley regulation to be greater than any perceived benefits from this reform legislation.

It is clear that investors and businesses no longer wholeheartedly favor the US public markets. Global markets have shown that they can be risky and dynamic, offering investors the growth and freedom they desire.

Sarbanes-Oxley's Beneficiaries

Not everyone is negatively affected by Sarbanes-Oxley. Accounting firms, private-equity groups, and large, established companies benefit from Sarbanes-Oxley's unintended consequences. And these benefits, to these firms, are not "perceived"; they are tangible and quantifiable.

The PCAOB's requirement of full external audits of internal control measures have made the simpler, less-expensive audits offered by smaller accounting firms inadequate for public companies. Sarbanes-Oxley's rules concerning "independence" have also forced most public companies to engage not one but two of the so-called Big Four accounting firms, for audit and compliance consulting functions. Between 2003 and 2005, annual revenues at the Big Four have increased by $15 billion.

Private equity and mezzanine finance funds have also seen increases in demand resulting from Sarbanes-Oxley. When companies are shut out of the public markets, they must raise money through more costly private sources. For existing public companies, going-private transactions are seen as an escape route. These companies have turned to ever

larger pools of private capital, which are able to extract large ownership stakes for equity deals and premium interest rates on debt.

Stephen Schwarzman, CEO of the large private equity firm, The Blackstone Group, recently said Sarbanes-Oxley "is probably been the best thing that's happened to our business and one of the worst things that has happened to America. It's taken a lot of entrepreneurial zeal out of a lot of corporate managers, and as a result of that when we talk to them about going private they're really quite excited."

Very large, established companies also gain from this law. Their large revenue streams make compliance not material to their overall corporate cost structure, giving them competitive advantages. Not so for small businesses. According to a study by the American Electronics Association, companies with under $100 million in revenues spent an average of 2.55 percent of their revenues on Sarbanes-Oxley-compliance in 2004. For a small company, that extra cost can be "make or break"—the difference between sustainable profitability and unsustainable unprofitable. So Sarbanes-Oxley is not only a barrier to entry for these smaller companies, it's a barrier to survival.

The federal government effectively provided a limited number of companies and organizations with windfall profits as a result of the unintended consequences of Sarbanes-Oxley. Their self-interest has caused them to become the major proponents of this law.

Sarbanes-Oxley Created an Unconstitutional Board

The PCAOB, created by Sarbanes-Oxley, is a self-regulating organization for the auditing industry, supported by a general power of taxation over all publicly-held companies.

The PCAOB raises its own revenue through taxation of public companies, which has allowed it to support a dramatic expansion in its size and scope. This board sets its own budget and salaries; the chairman makes $615,000 a year and the other members pay themselves $500,000 a year, well in excess of the president of the United States' salary of $400,000-- and more than triple what a Member of Congress earns.

The PCAOB exercises governmental powers, therefore its members are officers of the United States who must be appointed as the Appointments Clause of the Constitution (Article II, Section II) requires: by the President, with the advice and consent of the Senate. Because Sarbanes-Oxley establishes that PCAOB members are appointed by the Securities Exchange Commission, the law violates the Appointments Clause and is unconstitutional.

The PCAOB's interpretation of section 404 of Sarbanes-Oxley requires full external audits of all internal control measures, which goes beyond the 168 words of that entire section of the law. A significant portion of the adverse economic impact of Sarbanes-

Oxley is due to this aggressive interpretation by the PCAOB, which may have been far more reasonable if tempered by the constitutionally required political oversight.

Conclusion

America's public capital markets exist at the heart of our global financial preeminence, which is, in turn, a great source of our country's prosperity and economic growth. High value-added services, particularly financial services, are the high-productivity areas in which America must excel to compete in a world where our major competitors have plentiful and affordable labor.

Sarbanes-Oxley has become a classic example of overreaction – a massive expansion of regulatory power in response to a series of extraordinary events. And yet after all the costs and burdens of that massive over-reaction are added up, America's businesses are no better governed, are less transparently operated, and their shareholders are poorer. Americans and American businesses are worse off because of this well-intentioned, but poorly realized, piece of legislation.

The common interests of businesses, investors, and all Americans would be best advanced by rethinking, reformulating, and revising Sarbanes-Oxley.

Such reform, to reduce the counterproductive costs imposed by Sarbanes-Oxley, would enable our entrepreneurs, investors, and workers to go forward into the 21st century, confident that America can continue to lead the world in competitiveness, productivity, and economic abundance.

Thank you, once again, for giving me this opportunity to present the views of the Free Enterprise Fund and the Free Enterprise Institute on this urgent national priority.

Mr. McHENRY. Thank you. Thank you, Mr. Factor. I'll start off the questions and we'll put the 5-minutes on the clock which we'll try to stick to.

I enjoyed your testimony. I think you all have three unique perspectives and that's why it's wonderful to have you on the same panel.

Mr. Coulson, have you seen an uptick in your business with Pink Sheets well, since the passage of Sarbanes-Oxley?

Mr. COULSON. Since Sarbanes-Oxley, we've seen tradings and uptick in trading in our business, but it's not—the companies that are deregistered are not currently actively trading securities for the most part because they fall into—from that side, if you look at the 500 companies that are in the Pink Sheets, about half of their stock trade is below 50 percent, so I'd say they're economically distressed and they were having trouble any way and they may not have remained public companies. And other ones are the quiet, the guys who have deregistered, their companies are not accessing capital markets and they're not seeing the value portion of other companies controlled by a large shareholder who says it's not worth it to them.

But there hasn't yet been a windfall from SOX and what we're building with OTCQX, we're really building it to fit to either side because we look at the regulatory environment today and don't hope that it will change either way.

Mr. McHENRY. Mr. Wolkoff, have you seen activity in terms of, or a slackening in activity, in terms of IPOs new listings on your exchange? Or, have you seen companies going dark or delisting from your exchange since Sarbanes-Oxley?

Mr. WOLKOFF. It's not a simple answer because I think that up until about 2 years ago the AMEX was not being an effective competitor as far as attracting new listings. And over the last 2 or 3 years, we've seen an uptick because we've increased our efforts, our spending and so we have been actually taking quite a few companies both from IPOs or who have left the NASDAQ. Those seem to be the two.

We have seen some companies that have chosen to go private. One can always ask whether it might have been a more appropriate decision for that company in the first place and we have seen certainly a difficulty in attracting companies from outside the U.S. jurisdiction. Particularly for us, we have about 20 percent of our market in natural resources, exploration and production. Canada is a natural marketing place for us. And we've found that it's difficult, although we've had success, it is difficult success. It's challenging success.

Mr. McHENRY. Someone put forth the idea that in essence small cap companies have a disproportionate share of their profit being spent on compliance costs. So the idea would be a larger entity could purchase them and roll in their compliance costs and thereby increase shareholder value.

Have you seen mergers and acquisitions driven in that direction?

Mr. WOLKOFF. I've seen mergers and acquisitions. I could not say that's the cause or that should even be a desirable cause. The fact that entrepreneurial companies get absorbed into conglomerates or into companies that are simply larger, may not be the best growth

engine for the economy. We've always seen small companies being bought. In the pharmaceutical industry, a company, just to name one like a Pfizer, rather than spending 10 years developing a new pharmaceutical in-house, may simply choose to buy a company that has promise——

Mr. MCHENRY. I have a quick question. I'll get back to you.

Mr. Factor, in about 30 seconds, what do you advocate in terms of public policy? I mean short of repealing Sarbanes-Oxley which from your testimony I think would be a desirable thing, what would you say?

Mr. FACTOR. I think the most immediate need is to grossly exempt small and medium-size companies from Sarbanes-Oxley, No. 1. No. 2, I think you have to create PCAOB in a constitutional way. We believe it's totally unconstitutional under Section 2, Article 2 of the Constitution.

Mr. MCHENRY. OK, Mr. Wolkoff, in conclusion here, what can we do short of passing legislation to amend Sarbanes-Oxley right now, what would you advocate?

Mr. WOLKOFF. Yes, I think that some relatively straight-forward actions could be taken. No. 1, define Section 404 and what it might mean for companies of different revenues and of different market capitalizations, perhaps even in different lines of business. Require the accounting companies to put specificity within audit programs as to what the goals of a 404 audit would be. With respect to 404, depending upon the capitalization and revenues of the company, I would highly recommend that once a company complies with 404, that the certification be done not on an annual, but a biannual or a triennial basis, hence improving the cost factor.

And last, as to those smaller companies and I think there are quibbles about the actual market capitalization, but there should be a level of company that provided they have independent audit committee and other ethical-promoting corporate governance factors within the company should be permitted to choose and disclose that they're exempt from Section 404 and that the investor on the basis of that disclosure can choose to buy or not buy the particular stock.

Mr. MCHENRY. Thank you, Mr. Wolkoff.

Mr. Dent.

Mr. DENT. Thank you, Mr. Chairman. Thank you all for being here today.

As someone who represents a district where we have a lot of Main Streets as opposed to a Wall Street, I mentioned in my remarks about a lot of the small banks, in particular, have been very, very concerned about this law and the cost of compliance and it's been outrageous.

The question I have and it's probably directed to Mr. Factor, some of the supporters of Section 404 say that these compliance costs will dramatically decrease as businesses get streamline control processes. It would seem to me that regardless of the level of cost down the line, that the initial compliance costs associated with going public are a large enough deterrent to listing on U.S. exchanges. So how do you answer those——

Mr. FACTOR. I would say there are a number of people who say that, in particular, the accountants whose profitability has soared since Section 404 compliance has been made necessary by this.

I also believe that a number of the larger firms feel that Section 404 compliance should be kept because it's become a barrier to entry for small companies that really are the engine of America.

Section 404 is a disaster. I consider it my theory of holes. Section 404 came about because of the problems that occurred with Enron and World Com and we knew at that point that we were in a hole because of that. And what frequently is done and I quote Mr. Oxley "in a hothouse atmosphere excessive regulation comes about." And those are his words, "excessive" and "hothouse atmosphere."

What they did to get out of the hole, you just dug it deeper.

Mr. DENT. Well, thank you for that answer. And on the issue of mezzanine financing, can you explain what you mean by that term, one, and two, how does this distort the public capital markets?

Mr. FACTOR. The most efficient markets are the capital, are the public capital markets. They're extraordinarily efficient. They bring the cost of capital down. When you use private equity firms, the costs go up. There are not as many people involved.

Liquid markets bring the cost of capital down. Mezzanine financing firms are firms that are supplying equity, debt, sort of middle of the road instruments that capital markets and public capital markets, had supplied. But because of Sarbanes-Oxley, and the compliance costs, people have been avoiding it.

Remember, in an AEA study, companies under $100 million in revenues, 2.5 percent of revenues were spent on Sarbanes-Oxley compliance. That takes companies from profitability to unprofitability.

Mr. DENT. Thank you for that answer and I guess there's a question for all of you. I'll start with Mr. Wolkoff. You've all indicated there's a growing trend of smaller companies to list overseas. Basically, if the trend continues, what is this going to mean for Wall Street?

Mr. WOLKOFF. It's a loss of influence. It's a loss of jobs. Certainly, it's a lack of opportunity for us to grow. I think that the fact that Canadian companies and Australian companies choose to list on the AIM Market rather than their home markets is not really a positive about Sarbanes-Oxley. It simply means that their home markets are very small as far as access to capital and they need access to a larger market. The point being, they don't consider us.

When I was in Tel Aviv and London, recently, I could tell that my compatriots at the other national exchanges hadn't been there. They basically, I think, have thrown in the towel because the message is that it's too difficult to list in the United States. We haven't thrown in the towel, but what we're looking for is some ability to market U.S. capital markets and that means some modification in the requirement.

Mr. DENT. Are your foreign competitors aggressively marketing Sarbanes-Oxley against us?

Mr. WOLKOFF. Very aggressively. It's—in fact, for the AIM market, it is the major selling point. It is Sarbanes-Oxley on page 1, Sarbanes-Oxley on page 5 and Sarbanes-Oxley on the concluding page. And in fact, one of the reasons that we have a chance is that

Sarbanes-Oxley alone is not enough to overcome some of the problems with liquidity that these foreign exchanges have.

There's a quest to be in the United States. Companies want to be here if we show even a small amount of good faith in modifying some of the heavy-handedness of some of the rules. I'm not saying do away with it. I'm saying modify it and make it more sensible. Give us some tools to market to these foreign companies.

Mr. DENT. Thank you and I see my time is up. I yield back.

Mr. MCHENRY. Thank you, Mr. Dent. Ms. Kelly.

Ms. KELLY. Mr. Coulson, you mentioned in your testimony that a liquid market for the micro cap stocks can boost the GDP of our country by as much as 1 percent.

Do you think that the current SOX regulatory regime is really retarding growth in the Pink Sheet companies?

Mr. COULSON. There's two sides. The Pink Sheet companies has—a lot of Pink Sheet companies that are raising capital, there are issues where there should be more criminal and civil charges against the fraudsters which is needed more. And that's—there's an issue where there's a subset of smaller companies that just should be run out of town by the sheriff. And then there's another side on legitimate smaller companies that they don't understand the costs of what it will be to be public. They are not sophisticated. They don't have access to reams of law firms who can research a question. They need to be treated much more like the IRS treats a taxpayer, an individual taxpayer by the SEC, rather than how the IRS treats a corporation. And they need to be educated and they need to be brought into the system.

And that really doesn't happen from the SEC's viewpoint because they don't get phone calls when someone successfully invests in a smaller company that grows. They get a phone call when someone loses money in a smaller company. So their viewpoint is quite different and it's very enforcement based. And I wished there was more enforcement. There's more enforcement, but they also work to help companies engage in capital formation and that's really what they've done a great job with at the AIM. They have built a market for capital formation and the London capital—the capital of London has really directed itself at smaller companies. And that's what brings in entrepreneurship and GDP growth and all the good things.

Ms. KELLY. I'd like to go to Mr. Factor. You talked about the smaller companies having very high opportunity costs because of SOX 404.

I'd like you to elaborate a little bit on some of what the opportunity costs are and what—how much of an impact do you think that this is going to have on—not only the further growth in the industry sector, but also I'd be interested in your thoughts about what the impact of Sarbanes-Oxley is on New York State.

Mr. FACTOR. Well, I think New York State financial services industry has had preeminence around the world. And has been known—I think it's putting a very, very big dent in it. If you look at the major firms that are here, and they're also around the world as well, and they can move their people personnel and their transactions almost anywhere. We have seen a book by Tom Friedman called the World is Flat, how the world is flattening out and how

we have to be more competitive because things are becoming more equal. But what Sarbanes-Oxley does is tilt the world to other countries. We are really hurting our opportunities to create jobs, to create infrastructure and to grow and be productive.

Ms. KELLY. Do you think that this Section 404 has a strong impact on the smaller companies to the extent that it's going to really harm the market here?

Mr. FACTOR. It is harming it already. We've seen IPOs going overseas. We've seen the growth of private equity which is not as efficient from a cost point of view. We've seen companies choosing to go private. We've seen companies not choosing to go public. It means they don't have access to capital in order to grow. That's how we create jobs. That's how this country is built.

Ms. KELLY. That takes me right to Mr. Wolkoff who having been on—going on the American Exchange, I was very impressed with the active role that investors have in the smaller companies. And I'd like very much to have you elaborate a bit, if you would, on the burden that 404 places on the family controlled public companies where you have these very active investors.

Mr. WOLKOFF. I think there's a couple of categories. For the U.S. company, I think by and large, companies are internalizing the costs and continuing to list somewhere, if they're able to list. I think that the costs are significant. If one did a cost benefit analysis, I have no doubt that the cost benefit analysis would be much more heavily weighted toward costs than toward benefits. That being said, I can't say that Sarbanes-Oxley doesn't have certain good aspects to it or isn't appropriate in some cases, but for many companies, particularly science companies, like a company forming a new drug, they have a patent. They have no revenue, they have Sarbanes-Oxley costs that they have to incur and that just requires them to divert resources from the other things that they're doing.

Ms. KELLY. Thank you. My time is up.

Mr. WOLKOFF. May I just make one quick comment?

Ms. KELLY. Yes.

Mr. WOLKOFF. It will be under 15 seconds. You're talking about $35 billion that's being spent on Sarbanes-Oxley compliance under 404 that could be used for infrastructure, that could be used for innovation, that could be used to help us grow our economy and create jobs instead of being used for a full employment program for accountants.

Mr. MCHENRY. Thank you, Ms. Kelly. Mr. Feeney.

Mr. FEENEY. Yes, Mr. Wolkoff, I wanted to followup on some questions that Ms. Kelly had for Mr. Factor and I'm like Representative Dent. I don't have any exchanges in central Florida. Nothing is more liquid that I know of other than air and water than cash. And as investors can increasingly go on the Internet and invest their money in investments all over the world, I spoke to the chief financial officer in Hong Kong, Mr. Tong, I believe it is, and asked him whether or not a Hong Kong entrepreneur would think about listing on one of the New York exchanges and he laughed at me.

But why should an investor care? I mean the bottom line is as I have more opportunities to invest in Luxembourg or London, you know, 100 years ago, America took the lead, companies, houses like J.P. Morgan moved their central locations from London to the

United States, why should my constituents worry if more money is going to be raised through private equity firms. Mr. Coulson is developing a private regulatory network that doesn't have some of the absurd consequences. If Congress, the PCAOB and the SEC, deliberately or unintentionally, decide just to totally outsource liquid capital markets, other than the fact that folks on your exchange will lose jobs and Ms. Kelly may be hurt, why will this hurt investors in central Florida?

Mr. WOLKOFF. I'll admit, it wouldn't be a good thing for the American Stock Exchange, but we have to look at this in the context of two fairly discrete components, one being the companies themselves that seek to raise capital and the other being the investors. As far as companies that seek to raise capital, the more regulatory costs that are imposed on the company, the more expensive the cost of capital becomes the more likely it is that company will look to source capital either in some other jurisdiction or privately.

Mr. FEENEY. If I can interrupt, do you have an opinion on whether or not under Sarbanes-Oxley, as currently implemented, an Apple, a Dell or a Microsoft would have had an easy a time going for $50 or $75 million in capitalization to where they ended up?

Mr. WOLKOFF. I recently was on a panel with the CFO of Dell and I made the point and he didn't reject it entirely that the next Dell very well might be in the dorm room of a university located in Hong Kong or in Mumbai, but probably not in Texas, given the difficulty of companies to startup.

To the other part of your question, as to why investors would care, people have over-emphasized or over-stated, I think, the ease with which American investors can access foreign markets. It is expensive. There is a lack of transparency. There is a lack of access to regulatory assistance, regulatory certainty and there are currency issues that keep it from being as easily accessible as one might want. I think that is not an issue that would be resolved with Sarbanes-Oxley unless some modification began to get companies to do a list and bring their listings into the United States and accept U.S. jurisdiction and I believe that there is a great hunger in the rest of the world to access American capital markets, but that they're being deterred from doing so.

Mr. FEENEY. Mr. Wolkoff, in your testimony, you talked about, one of the things we do in the Compete Act is we allow companies to voluntarily comply or disclose if they're not going to comply and let the investors determine what the premium would be to comply with certain regulations. If the regulations turn out to be absurd, then the liquid will follow the rational regulatory scheme.

But in addition, two things that we think are important and tell me how this would play on AMEX, because you do have a few large cap companies listed.

Mr. WOLKOFF. Yes, we do.

Mr. FEENEY. We require a very strenuous definition of what a de minimis standard is, so that not every box of paper clips on the planet is—we have this sort of this race to the absurd in the regulatory scheme because everybody's threatened with civil and criminal liabilities.

How important would that be?

And then second, we suggest that the outside audits which are totally redundant, I mean they do keep people honest, but those people already are subject to civil and criminal death penalties. So they're redundant.

Supposing we made the external audits random so that the AMEX could decide, for example, every 10 percent of its companies, randomly selected, do you think it would have the same chilling effect against fraud that SOX was designed to get at? Can you address those two issues, the de minimis standard and the potential for random external audits?

Mr. WOLKOFF. Yes, Congressman, I liked your bill. I thought it was well thought through and considered the important issues——

Mr. FEENEY. Mr. Levitt didn't think so. He was the author of SOX or claims. He wasn't so happy.

Mr. WOLKOFF. Mr. Levitt and I don't necessarily agree on a number of issues, so that's not really the standard of whether you've done a good job or not. I think you have done a good job. I think that one, the need to have definition, the need to provide rationality to what's required so that how you maintain a box of paper clips, as you say, really doesn't come into an overview of your internal controls. I also agree with you as far as the ability to opt out of regulations so long as that's disclosed and there are some other protections.

I think that any effort to provide clarity, to provide lesser scope of regulation on smaller companies, to allow the investor to make up his or her own mind based upon appropriate disclosures, I think those are all good things and I agree with my colleague from the Pink Sheets, that an increase in enforcement dollars would also go a long way. I think seeing Mr. Lay and Mr. Skilling convicted has done more benefit for American capital markets and the trust in them than all the bills in the history of the U.S. Congress possibly could have.

Mr. MCHENRY. Any further questions from the panel?

Ms. KELLY. I'd like to throw one out if you don't mind.

Mr. MCHENRY. Certainly.

Ms. KELLY. We're trying to look at what will generate a liquid market that will grow the economy. To do that, it's very difficult because we don't have a statutory—a real statutory definition on what we should be regulating here. As you've all pointed out, the large companies don't have a great deal of—it doesn't have that big of an impact, but these smaller, these nascent companies that are coming into the market, things that Mr. Coulson, the entities Mr. Coulson, and you, Mr. Wolkoff, often deal with, should we look at a cap on the capitalization of a company? Where would you set the marker if you were rewriting this bill? And Mr. Feeney's bill does the kinds of things that I feel are good. That gets the government, let industry itself decide. But if we have to rewrite the bill in some way, would you put a cap on it—on capitalization, on the amount—certainly not the profitability, but where would you go with trying to rewrite this so it makes sense?

Mr. WOLKOFF. Are you asking me?

Ms. KELLY. I'm asking all of you.

Mr. WOLKOFF. I think that there should be exemptive authority. I think that there are some companies that should be able to dis-

close that they're not complying and the reasons why and I think in the case of say companies that are looking to discover a new medical device or a new pharmaceutical, and have very little revenues, Sarbanes-Oxley is not the reason people are buying those stocks and I think that would be completely understandable.

I believe that there's probably quite a bit that can be done, even in the absence of legislation, simply by giving definition, by continuing certain exemptions as they exist, by giving a break, really, to foreign companies, who want to try to access American capital markets and aren't going to have half of their shareholders be U.S. citizens, but some smaller amount. I think that all of these things are worth trying. I think that there are people with greater knowledge of the application of accounting rules and securities laws than perhaps I have, but like the panel, I do have concerns that what we have right now is heavy handed, is excessive, is hurting American capital markets and is hurting American business as well, and should be rethought in every fundamental way in order that we can become competitive with the rest of the world without lessening those standards that are most important to investors.

Mr. FACTOR. What I think needs to be done is 404 needs to be done away with. Mr. Wolkoff talked about two people who got convicted. There were over 700 convictions since Sarbanes-Oxley was enacted, well over 700 and fines galore, none of them under Sarbanes-Oxley.

What we don't need is additional legislation and regulation. What we need is to take the regulation that we have and legislation that we have and use it properly. The fundamental problem is that once the—once you have in power town D.C., once you have an Enron and World Com, it's like that the regulatory dinner bell ringing and the bureaucrats come rushing to the table with new organizations that just add enormous costs to our society. And it's hard to dislodge it. And what we need to do is dislodge them under 404. We need to dislodge them by getting rid of 302 which criminalizes, in many cases, taking risks. We need to really think this thing—this thing needs to be thought through thoroughly and say what legislation do we really need to give America the opportunity to grow and prosper and create jobs.

The only thing I can tell you is we filed a lawsuit to challenge the constitutionality of the Public Company Oversight Accounting Board [PCAOB]. On the day we filed it, it was the day that PUHCA, which is the Public Utilities Holding Company Act of 1935, finally was gotten rid of. It was an overreaction in 1935 to Sam Ingersoll and in many ways it was a Stalinist act in the way it was written. It allowed the SEC to bust any multi-state utility holding company. Sometimes the gross overreaction really hurts our country and Sarbanes-Oxley does that.

Mr. FEENEY. Mr. Chairman, I wonder if I could ask one more and with respect to 302, my bill doesn't touch that, but if you do define de minimis standards, the criminal penalties become a lot less arbitrary.

Does any of the three panelists have a very quick opinion, the PCAOB and the SEC appointed a small business advisory committee. I thought their recommendations—I've been working on this

for 8 or 9 months and I thought their recommendations were prescient since my bill was written, but not quite filed yet.

Does anybody have an opinion why they, for the most part, nodded and then went about their merry way without adopting the most important of the advice given by their own advisory committee?

Mr. COULSON. I watched that panel very closely and I think their report is actually a great report on the state of small company market past 404 and Sarbanes-Oxley. And there's a lot of other points they raised that should be followed through on.

They went for the long pass, get rid of it. And it's much harder to go through and decide which controls are material to investors and I think a great process will be if the SEC can do it and the PCAOB is go through, figure out what the controls are at small companies and figure out which ones are material to investors and what's the cost benefit and say OK, here's 10 controls you need when you're this market cap. Here's 50. And let's really, because SOX 404 is like a rule in Small Town, USA that says every house has to be painted every year, but the painter decides when he's done and you're paying him by the hour. That can't work.

You need to be able to cutoff your accountant and say we're done on the audit and this is what the regulators say you have to do. And that hasn't been done. And that's the real nightmare and people are running around, the sky is falling. There are SOX consultants who will say pay me hourly and I'll tell you how the sky is falling.

There needs to be reined in and while—I agree with many points of Mr. Factor, and maybe we should get rid of it, but dealing with going forward, we really need to rein in the cost for the small company and give them some comfort.

Mr. MCHENRY. And with that, thank you so much for testifying today. Mr. Coulson, I think you had a great line there at the end about the housepainter. I think it's very well stated.

Mr. COULSON. Thank you.

Mr. MCHENRY. And thank you so much for taking the time to testify before us. This information is very important to us, to ensure the strong nature of our financial markets going forward.

With that, we're going to have a set for 5 minutes for the next panel, and this panel will stand in recess for 5 minutes.

[Recess.]

Mr. MCHENRY. The committee will come back to order. I welcome the second panel. Thank you for taking the time to be with us today. Thank you for waiting your turn.

Because the Government Reform Committee has subpoena power, we always swear in the witnesses as you heard with the previous panel, so if you would all please rise and join me. Raise your right hands.

[Witnesses sworn.]

Mr. MCHENRY. We note in the record that all the witnesses responded in the affirmative. With that, I'd like to recognize my colleague from Pennsylvania, Mr. Dent, for the purposes of three introductions and Ms. Kelly for the fourth.

Mr. DENT. Well, first I'd like to introduce our next witness today which is Mr. Robert Robotti. Mr. Robotti is the president and man-

aging director of Robotti & Co. He recently served with distinction on the Securities and Exchange Commission's Advisory Board on Smaller Public Companies. He holds a B.S. degree from Bucknell University, about 100 miles up the road from me and an M.B.A. in taxation from Pace University. We're glad to have you with us here today, Mr. Robotti.

I'd also like to welcome Mr. William Beach, director of the Center for Data Analysis [CDA], at the Heritage Foundation. Mr. Beach previously served as president of the Institute of Humane Studies at George Mason University in Fairfax, VA; previously, unranked basketball team, by the way, which made it in this year's Final Four. He is a graduate of Washburn University and he also holds an M.A. in history and economics from the University of Missouri, Columbia. Thank you for being here.

And then we'll also hear today from Mr. John O'Shea. Mr. O'Shea is the president and chief executive officer of Westminister Securities Corp. He is an allied member of the New York Stock Exchange and a member of the New York Board of Trade and Securities Traders Association. He holds both a B.A. and M.A. in economics from the University of Cincinnati. Welcome.

Ms. Kelly.

Ms. KELLY. Thank you. Our final witness today is Mr. David Lawrence who is the chief financial officer of Acorda Therapeutics, Incorporated. Mr. Lawrence is a founding member and currently serves on the Board of Directors as treasurer of the Brian Hearn Children's Fund. He is a graduate of Roger Williams College and received his MBA in Finance from Iona College. And we thank you all for being here.

Mr. MCHENRY. And with that, we'll start, just a reminder for this panel, as you heard before, there's a 5-minute time limit for opening statements. You'll see the yellow light come on. We have 1 minute left at that point. I'd wrap up if I were you.

And with that, Mr. Robotti.

STATEMENTS OF ROBERT ROBOTTI, PRESIDENT, ROBOTTI & CO.; WILLIAM W. BEACH, DIRECTOR FOR DATA ANALYSIS, THE HERITAGE FOUNDATION; JOHN P. O'SHEA, PRESIDENT AND CEO, WESTMINSTER SECURITIES CORP.; AND DAVID LAWRENCE, CHIEF FINANCIAL OFFICER, ACORDA THERAPEUTICS, INC.

STATEMENT OF ROBERT ROBOTTI

Mr. ROBOTTI. Hi. Thank you for the opportunity to testify today. I was recently a member of the Securities and Exchange Commission's Advisory Committee on Smaller Public Companies and, as such, served as a member of the Corporate Governance and Disclosure Subcommittee. The SEC, of course, established the Advisory Committee to examine the impact of Sarbanes-Oxley and other aspects of Federal securities laws on smaller companies.

Professionally, I am both the Founder and Managing member of an investment partnership, which SEC rules require me not to name, and the Founder and Portfolio Manager of Robotti & Company Advisors, LLC, an SEC-registered investment advisor. Both of those entities, I direct the investment of slightly over $300 million,

the vast majority of which is invested in small cap and micro cap companies.

I am also a director of Panhandle Royalty Co., a publicly traded $160 million market cap company. I am a member of Panhandle's Audit and Compensation Committees and as such I am familiar with one company's travails with Sarbanes-Oxley's Section 404. I would point out that, as a board member, it is a logical predisposition to reduce one's potential personal liability by encouraging a company to overspend on Section 404 compliance.

I will address you today primarily as an investor in small cap and micro cap companies, i.e., someone to whom the benefits of Sarbanes-Oxley are directed. Let me start by describing our investment process. We are what is commonly characterized as bottom-up equity investors. Our stock selection is predicated on the research and evaluation of fundamental company data. Therefore, we are primarily interested in an issuer's annual audited reports as well as its interim financial statements which companies registered with SEC are required to publicly disclose. It goes without saying that the reliability of that data is paramount to our investment decisions. Once we invest, we think and act like owners. This includes continuous evaluation of management and the board's oversight through assessing their capital allocation decisions.

Again, both audited annual reports and interim financial statements are fundamental tools utilized in this investment process. Therefore, I am a proponent of expenditures of time and money in producing such reports which benefit us, the investors and owners, by providing us with timely financial and other information abut an issuer.

Let me point out that we know, from many years of investment in public markets, managements and boards occasionally fail to act in shareholders' best interest or even fail to attempt to act in shareholders' best interest. The document, the critical evaluation on our part of managements and boards, I can point to the fact that I and the entities I direct have been named plaintiffs in numerous lawsuits against companies in which we had invested as a result of our efforts to protect and we took these efforts to protect shareholder interests.

So when management of our invested companies states "the cost and effort of compliance with Section 404 is disproportionate to its benefits," I listen with healthy skepticism.

I think it's important to point out that I strongly support the vast majority of the investor predictions provided by Sarbanes-Oxley: the independence requirements for the audit committee, the restrictions on loans to insiders, the whistleblower provisions as well as other restrictions on services by independent auditors, etc. The vast majority of the law is a tremendous step forward for shareholders. There are costs, both hard and subtle, exist, but my personal investing experience convinces me that the net benefit to shareholders is significant. Therefore, we support—and the support of these protections enumerated in SARBOX is documented by our committee's work at the SEC also.

But then there is Section 404, where I believe some moderation with respect to its implementation would be practical. Conceptually, Section 404 compliance requires detailing, documenting and

testing data pertinent to the reporting process. Realistically, Section 404 needs to be significantly right-sized. I further believe that the time and attention now required by top management of small companies to fully comply misapprpriates shareholder value. This is subtly more relevant to smaller companies than it is to larger ones, for large companies the time and effort required by 404 can be delegated to staff who are not charged with running company. For smaller companies, senior management spends a substantial amount of their time on 404 when they could be running the business. Instead, they're dealing with the compliance of Section 404. My perspective is based on my years of experience, observations and evaluations of companies and their managements.

The misallocation of management's time and attention, as well as the hard costs paid to outside auditors and consultants are not the only negatives. The costs associated with complying with Section 404 continue to motivate small companies which do not plan on raising capital to deregister or go dark. When a company deregisters or goes dark the company can do this in a relatively short period of time. It ceases to be required to make annual financial statements and interim reports publicly available. It becomes, in essence, a private company with public shareholders. Since the vast majority of the universe of small companies has no plans on raising capital, the majority of these companies are candidates to go dark. It is probably in their fiduciary duty actually as directors and managements to consider this option.

Small companies that have deregistered or that are part of the—planning to deregister, have to consider the huge costs associated with Section 404 compliance. And this is one of the unintended consequences. The GAO report itself identifies this as a problem and identifies that there was a significant increase in the companies that are deregistering. Out of 5,971 SEC registered companies today who are non-accelerated filers. I'm going to skip through since I've got plenty more.

We're concerned also about that impact that it was because a lot of the discussion really talks about companies raising capital, becoming public. What we're forgetting about is that there's a huge disenfranchised investor base out there who are shareholders in these companies and potentially are going to be subject to—there are almost no regulations in terms of what information will be available to and how they can evaluate these companies. That's a significant factor.

Thank you.

[The prepared statement of Mr. Robotti follows:]

Testimony of Robert Robotti
President of Robotti & Company, Incorporated

June 19, 2006

U.S. House of Representatives Government Reform Subcommittee on Regulatory Affairs

Thank you for the opportunity to testify before you today.

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Let me point out that we know, from years of investment in public companies, managements and boards occasionally fail to act in shareholders' best interests or even fail to attempt to act in shareholders' best interests. To document our critical evaluation of managements and boards I can point to the fact that I, and entities that I direct, have been a named plaintiff numerous times in lawsuits against companies in which we have invested as a result of our efforts to protect shareholders' interests. So when the

management of our invested companies state "the cost and effort of compliance with Section 404 is disproportionate to its benefits," I listen with healthy skepticism.

I think it's important to point out that I strongly support the vast majority of the investor protections provided by Sarbanes-Oxley: the independence requirements for the audit committee, the restrictions on loans to insiders, the whistleblower provisions as well as the restriction on other services by independent auditors, etc. The vast majority of the law is a tremendous step forward for shareholders. There are costs, both hard and subtle, but my personal investing experience convinces me that there is a net benefit to shareholders. Support for these protections enumerated in SARBOX is documented in our Committee's report to the S.E.C.

But then there is Section 404, where I believe some moderation with respect to its implementation would be practical. Conceptually, Section 404 compliance requires detailing, documenting and testing data pertinent to the reporting process. Realistically, Section 404 needs to be significantly right-sized. I further believe that the time and attention now required by top management of small cap companies to fully comply misappropriates shareholder value. This is substantially more relevant to smaller public companies than larger ones. For large caps, the time and effort required by Section 404 can be delegated to staff who are not charged with running the company. For smaller companies, senior management spends a substantial amount of time they could be running the business on compliance with Section 404. My perspective is based on my years of experiences, observations and evaluations of companies and their managements.

The misallocation of management's time and attention as well as the hard costs paid to outside auditors and consultants are not the only negatives. The costs associated with complying with Section 404 continue to motivate small companies, which do not plan on raising new capital to deregister or "go dark." When a company deregisters or "goes dark" -which any company can do in a relatively short period of time- it ceases to be required to make its annual financial statements and interim reports publicly available. It becomes in essence a private company with public shareholders. Since a vast portion of the universe of smaller companies has no capital raising plans the majority of these companies are candidates to "go dark." (It probably is the fiduciary duty of Boards of Directors and management to consider this option.)

Small cap companies that have deregistered and those planning on doing so have cited the high costs associated with complying with Section 404 of The Sarbanes-Oxley Act of 2002. The unintended consequence of some of the more extreme mandates set forth in Section 404 has been evidenced by the torrent of healthy, small cap companies that have chosen to voluntarily deregister or go-private. The GAO Report documents this fact, where it is estimated that 267 companies will have gone dark in 2005 compared to 143 in 2001. The report also points out that 5,971 companies currently registered with the SEC are non-accelerated fillers. More importantly, the report states that the vast majority of smaller public companies have yet to resolve this compliance dilemma, but the next year's compliance deadline approaches. It will certainly be interesting to see how the public and media react to a potential wave of deregistration or "going dark" transactions. I would ask are investors better served by exempting small companies from Section 404

compliance, or being set adrift owning shares in a company that no longer publicly reports its financials? Is this "investor protection?" Do we understand what "going dark" means? And who is affected? There is no exit provided to investors in a going dark transaction. This is unlike a going private transaction where shareholders are paid for their shares and can go to court if they think they have been paid an unfair amount. . After a company goes dark, shareholders lose the oversight of the SEC and the requirements of regular financial and information reporting. Shareholders are in large measure subject to the unilateral whim of management as to the disclosures they choose to release to the public. That is why it is referred to as "going dark." Again I ask, is this "investor protection?"

Investors in such companies pay a heavy price through generally lower stock prices. In most cases it is costly to shareholders both in the short term and very likely in the long term as well. The most immediate fact is that the shares will no longer be traded on regular securities markets but instead will trade in the "Pink Sheets." The normal effect of which is a lower market price for the shares. Then, with fewer disclosures, the shares often will trade lower yet. Investors in these companies will have none of the safeguards its shareholders had thought they would receive from SEC oversight and all the other protections enumerated in Sarbanes-Oxley. The SEC's mandate is to provide investor protection – so much for that! The long term effects of a deregistration can be even more onerous as investors' rights to information are extremely minimal in this environment. The only rights will be those provided by be the statutes of the company's State of Incorporation, and the company's charter documents. In most cases these rights are extremely limited and often require an investor to litigate against the company to actually

obtain information, a process few investors will undertake. The shareholders are now in "the dark" as to developments at their company.

I, as an investor, would gladly forgo the protections of Section 404 in return for having companies continue to publicly report their annual and interim financials.

I would further point out that the investor community, the lending community and even the auditing community appear to ascribe no value to Section 404 compliance.

I believe that equity investors in smaller public companies have registered their opinion minimizing any value from Section 404. Since the passage of Sarbanes-Oxley, small & micro cap companies have significantly outperformed their larger brethren who have implemented Section 404. Of course, there are many reasons why the market behaves in certain ways in the short term. It is not just this issue that investors consider but it is clear there has been no repricing and revaluation of those companies that have not yet implemented 404. (The same cannot be said for those companies that have gone "dark," the securities of which have generally declined in value.) If investors ascribed value to the Section 404 compliance the prices of companies which have not yet complied with Section 404 should have declined to reflect this heightened risk to investors. That has not occurred.

As for the lending community, if they believed there was significant value in Section 404 compliance one would expect that lenders would require voluntary early implementation as a prerequisite to credit extensions. I have not had the management of any of our

investee companies indicate to us that such a demand had been made by their lenders and have not seen any such companies Section 404 compliance prior to when required.

The lending community has provided us with an example by which we can assess the merits of the requirements prescribed in Section 404. As such, it has become evident to us, based on the companies in which we have invested, that neither the cost of capital nor the availability of additional financing has been impacted by lack of Section404 compliance.

Finally, for a number of our companies which have not yet been required to implement Section 404, the Big 4 accounting firms continue to issue audit reports even though these companies are higher risks, as they have not implemented Section 404.

In conclusion, I believe the research process starts with an appraisal of a firm's financial statements and an assessment of the analogous investment risks. The disproportionate distribution of costs associated with Section 404 compliance on smaller companies will force many of such firms to deregister and de-list, thereby leaving investors with less information upon which to make investment decisions and fewer investment opportunities. Furthermore, Section 404 is not a panacea. The growth of the population of deregistered stocks will surely create new issues. When these unintended consequences are considered, it becomes quite clear that moderating the requirements of Section 404 is sensible legislating.

Mr. McHenry. Thank you, Mr. Robotti.
Mr. Beach.

STATEMENT OF WILLIAM BEACH

Mr. Beach. Thank you for the opportunity to testify before you today, to come all the way from Washington to New York where it's even warmer, apparently, than down there.

Policymakers at all levels of government, but particularly at the Federal level have a number of prime directives that govern their work: design and run efficient programs, change policy in line with the changing world in which the policy lives, listen to citizens and their elected representatives and due no harm.

Within that list, clearly the last ranks highest in my view. At the risk of using an inappropriate analogy, the cure must not be worse than the disease. Doubtless, the most profound change in financial market regulation in the past decade occurred with the passage of the properly titled Sarbanes-Oxley legislation in 2002. There's an adage that I learned in the law and that is hard cases make bad law.

Today, analysts are acquiring evidence that the reaction of Congress to transitory financial market problems and to the enveloping recession created law and subsequent regulation that has harmed markets, the creation of new businesses and consumer well-being, as well as the general level and quality of U.S. economic activity.

Our own research in the Center for Data Analysis indicates that Sarbanes-Oxley may have had a negative effect on the volume of private equity deals independent of the influence of a poorly performing economy that surrounded investment decisions in the first 2 years following the passage of the act.

The key ingredients of a well-functioning dynamic system of financial markets or financial information and entrepreneurship, there's no question about that. There are hardly any two factors more important unless it is the sheer volume of new business ideas and supporting entrepreneurial activity that produce markets in the first place. Economic activity can be harmed by government and these things can be harmed by your acts. While no one denies that good reporting of financial results is important to market performance, honest 10Ks are preferred over dishonest ones. Markets can punish crooked companies much faster than you can and more severely than you can or the courts. In fact, the price system can move so swiftly against businesses that some stock exchanges actually have rules for stopping trading in a company's equities when prices fall by a certain percentage.

Let me describe the research that we have done. There is increasing anecdotal and statistical evidence that Sarbanes-Oxley has created damaging distortions in the price system. Ladies and gentlemen, the price system is a natural resource, all right? It isn't something that you've created or we've created. It's what we human beings have created and it's your duty to defend it.

Our own research on this possibility has focused on changes to venture capital funding after passage of SARBOX. Venture capital funding reflects all aspects of the problem described here; entrepreneurial activity, it has capital costs, investor decisions, financial

reporting requirements and in some cases, it will even have a public-traded moment.

If Sarbanes-Oxley appears now to exercise a deleterious effect on financial markets, then the venture capital industry should provide an early indication of that effect, kind of like the canary in the cave. The staff of the Center for Data Analysis collected monthly data on venture capital deals from 1995 onwards. Our data came from Thompson Financial Services Venture Economics Web site. These data included the volume of deals in their total value, commitments in IPOs. Data were also assembled from other CDA economic models on the U.S. economy. After all, the venture capital industry was severely affected by the collapse of the dot com bubble in the fall of 2000 and 2001. The time period also saw the debate over more financial regulation heating up. So the key problem that we had to solve was how do you separate the collapse of the venture capital market from the effects of Sarbanes-Oxley? It's a very delicate, statistical problem.

The analytical results from running a model of private equity deals contains ways of tickling out these effects, indicates that the anecdotal evidence is, in fact, very correct and that Sarbanes-Oxley actually reduced deals and we are currently updating the model with new and more recent data and we'll supply this committee with that when it becomes available.

We also tested the same model with an appropriate number of time period lags for two additional measurements: fund commitments and initial public offerings with the same result. Now why was this result there and I'll conclude on this and we can do it in the queries that follow. What happens in Sarbanes-Oxley is that the regulatory cost and the uncertainty adds to the cost of capital. It's the uncertainty factor which is actually the worse part as far as we can tell from the data. And the uncertainty factor raising the cost of capital and also raising the possibility of failure in the future has caused the deals to collapse in the way that we saw them. And we don't see that as something that's recovering any time soon.

Remember, for every one tenth of a point, in capital costs brought about through government's own actions, there's 100,000 or so jobs lost, potential jobs in the economy. So there's a direct result outside of the deals to the general macro economy.

I'd be happy to answer questions.

[The prepared statement of Mr. Beach follows:]

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Congressional Testimony

Testimony of

William W. Beach
Director of the Center for Data Analysis
The Heritage Foundation

Before the

House Committee on Government Reform

Sub Committee on Regulatory Affairs

New York City

June 19, 2006

Testimony of William W. Beach

Policy makers at all levels of government but particularly at the federal level have a number of "prime directives" that govern their work: design and run efficient programs, change policy in line with the changing world in which the policy lives, listen to citizens and their elected representatives, and do no harm. Within this list, clearly the last ranks highest. At the risk of using an inappropriate analogy, the cure must not be worse than the disease.

In the arena of public policy dealing with financial markets and the information instruments that are so vital to those markets, there is little controversy among economists as to the public sector's principal policy duty. Policy makers should pursue means that encourage the growth of information systems that support vibrant financial markets where relatively low-risk experimentation with new companies and products can take place. Sound financial markets turn on sound financial information.

Doubtless the most profound change in financial market regulation occurred with passage of the popularly titled Sarbanes-Oxley legislation in 2002. Congress enacted this legislation to address the succession of corporate financial scandals that began with Enron in 2001 and grew with revelations of financial wrong doing at Global Crossing and WorldCom. The legislation was surrounded by an emotional debate over the fate of these important companies and their employees and the worsening recession that began just as the scandals were breaking.

There's an adage in law that says hard cases make bad law. Today analysts are acquiring evidence that the reaction of Congress to transitory financial market problems and to the enveloping recession created law and subsequent regulation that has harmed markets, the creation of new businesses and consumer well being, and the general level and quality of U.S. economic activity.

As described below, our own research indicates (though it does not prove) that Sarbanes-Oxley may have had a negative effect on the volume of private equity deals independent of the influence of a poorly performing economy that surrounded investment decisions in the first two years following passage of the Act.

The key ingredients to a well-functioning, dynamic system of financial markets are financial information and entrepreneurship. There are hardly any two factors more important, unless it is the sheer volume of new business ideas and supporting entrepreneurial activity that produce markets in the first place. While regulators will certainly nod in the direction of high-quality information (and, indeed, the inspiration of Sarbanes-Oxley rose from the desire for better information) and entrepreneurship, many policy makers and regulators have an incomplete appreciation of how markets use information and depend on knowledge.

Investors who enter a financial market obviously are unable to know everything about a company's stock they are thinking about buying. They cannot know about

unrecorded conversations that have taken place between company executives concerning the business's future prospects. They cannot obtain without great difficulty the information they would want about the company's suppliers or customers or, indeed, other investors. Even if they could obtain written information about all of these things, that information would be significantly outdated by the time the investor buys the stock. The company executives conceivably could totally change their view of the company's prospects, suppliers could depart in mass on the basis of some rumor the day after the investor gets his or her information, or customers could decide that this company's product is the next big thing and swing toward it overnight.

Given these obstacles to getting obviously important information, it is amazing that anyone buys stocks and company bonds. Imagine the enormous risk of failure from significant lack of failure that investors would face if that had to rely solely on their own ability to collect these kinds of data. Imagine how few investments would be made if some other information system failed to be in place.

Fortunately for financial markets, such a "good-enough" information system is working all of the time. It is called the price system, and it provides highly reliable signals about a host of developments that otherwise would be impossible to obtain. Thousands of investors daily look at the same company and supply information to financial markets by their decisions to buy, sell, or hold company stocks and bonds. An individual investor doesn't need to know the internal company gossip about a big, lost contract to sense that a steeply declining stock price signals some kind of problem. The investor may just want to invest in, say, technology companies; and he or she accomplishes this end by purchasing interests in a technology mutual fund, and will buy or sell based on the direction of the fund's price. In this instance, the price system allows successful investment without hardly any information about individual companies.

The virtually unimaginable economic gains that come from relying on price movements for information rather than "hard" data makes the defense of a well-functioning price system one of Congress's top priorities. I say "defense" because the price system is almost a natural resource, and it is as worthy of preserving as our water and air. Government certainly didn't create it, and there appears to be no moment in history when it suddenly emerged. Rather, it is a natural part of human life and, as such, central to our social and economic future.

It can, however, be harmed by government. While no one denies that good reporting of financial results is important to market performance (honest 10ks are preferred over dishonest ones), markets can punish crooked companies faster and more severely than courts or legislatures. In fact, the price system can move so swiftly against a business that some stock exchanges have rules that stop trading in a company's equities when prices fall by a certain percentage over a certain time period.

Government oversteps its duty to defend the price system when it imposes laws and regulations that create uncertainty or significant additional compliance costs. Uncertainty and additional costs get built into the price of stocks and bonds as regulatory

premiums. That is, a regulation that has an uncertain effect or interpretation creates a risk that company management may not have fully complied with the government's requirements. Investors will demand higher returns in the short-term to compensate them for potentially lower returns in the future following the imposition of regulatory penalties. This investor demand for higher returns is reflected in the stock's price, which is discounted for risk.

If these government risk premiums are great enough, they can substantially distort market prices. When such distortion occurs, the vital information that investors need for efficient decision making is either obscured or lost.

There is increasing anecdotal and statistical evidence that Sarbanes-Oxley has created damaging distortions to the price system. Our own research on this possibility has focused on changes to venture capital funding after passage of SarBox. Venture capital funding reflects all aspects of the problem described above: entrepreneurial activity, capital costs, investor decisions, financial reporting requirements, and (in some cases) publicly traded equities. If Sarbanes-Oxley appears now to exercise a deleterious effect on financial markets, the venture capital industry should provide an early indication of that effect.

The staff of the Center for Data Analysis collected monthly data on venture capital deals from 1995 onwards. Our data came from Thomson Financial Services' *Venture Economics* website. These data included the volume of deals and their total value. Data also were assembled from other CDA economic models on the US economy. After all, the venture capital industry was severely affected by the collapse of the dot com bubble in the fall of 2000 and winter of 2001. That time period also saw the debate over more financial regulation heat up. Thus, the key analytical problem faced by my staff was distinguishing statistically the effects of the recession on venture capital deals from the effects of Sarbanes-Oxley.

We addressed this problem by constructing a model that attempts to explain the change in private equity deals[1] by following changes in an indicator for the economy (in this case employment), change in the S&P 500, prior private equity deals, and indicators for various time periods, one of which is the period following the passage of Sarbanes-Oxley.

The analytical results from running this model of private equity deals appears to confirm the anecdotal evidence that Sarbanes-Oxley reduced the volume of deals. We are currently updating the model with new and more recent data, and will report our revised results to the Committee when they become available later in the summer.

We also tested the same basic model, with the appropriate number of time period lags, for two additional measures: fund commitments and initial public offerings (IPO)

[1] Private equity deals is defined as the universe of all venture investing, buyout investing, and mezzanine investing, which is a fund investment strategy involving subordinated debt, or the level of financing senior to equity and below senior debt.

of venture firms. *Venture Economics* defines "Fund Commitments" as a limited partner's obligation to provide a certain amount of capital to a fund. IPO data are monthly time series from January 1970 and the commitment data are quarterly time series from the first quarter of 1980.

Using these measures, the estimates on the time indicator for Sarbanes-Oxley were all negative, but the overall results are not as reliable as those found using private equity deals. Two of the main reasons for this disparity are the data: the IPO data only represent the *Venture Economics* IPO universe, and the commitment data span a shorter time period with a lower frequency (quarterly vs. monthly). For all of these measures, the time period variables were found to be negative, but of a smaller magnitude with a larger standard error. We believe that these results also will become more robust with the addition of new data.

Economists can provide the inferential and general evidence that confirms what you hear anecdotally. That is, we have some evidence that Sarbanes-Oxley reduced venture capital activity, possibly by increasing the risk premium on investment because of the uncertainty surrounding what the law would require.

If this statistical evidence grows as more data become available, and other researchers find similar effects in other parts of the financial sector; then policy makers will find themselves better able to assess the costs and benefits of Sarbanes-Oxley. Due to the linkages between changes in investment and in employment and wages, this body of evidence may soon be sufficiently weighty that debate over the future of Sarbanes-Oxley will spill out of the policy circles in Washington and into the general political discussion over the economic future of the country.

Mr. McHENRY. Thank you, sir.
Mr. O'Shea.

STATEMENT OF JOHN P. O'SHEA

Mr. O'SHEA. I would like to first express my appreciation for the opportunity to speak before the Subcommittee on Regulatory Affairs and share my views with regard to the costs and benefits of Sarbanes-Oxley. This is an issue of great importance to small businesses in America, as well as the financial community, regulators, and others who provide services to this vital segment of the American economy.

I'm speaking before the subcommittee from a dual perspective: first, as president, CEO and owner of a New York Stock Exchange and NASD member firm and as a small business issuers as clients; and second, as an individual who has invested personally in many SBIs and also has acted as an officer and director of SBIs.

I've worked with SBIs for over 20 years, and have witnessed numerous changes in regulations that have significantly improved the transparency of small capital markets, particularly the Over-the-Counter Bulletin Board. While some of these regulations placed increased burdens on issuers, they were regulations aimed specifically at smaller issuers for the purpose of enhancing disclosure and market liquidity for smaller public companies. By contrast, the Sarbanes-Oxley Act has placed a broad-based burden on publicly held companies of all shapes, sizes and characteristics. While there are many positive aspects of the act, such as those regarding conduct and related-party transactions, the audit and review standards are particularly onerous.

In the case of larger companies, I believe the burden can be absorbed with reasonable impact and the benefits are realized by a large number of investors. In the case of smaller public companies, however, I believe the cost, in terms of both financial impact and management resources, has a disproportionately large effect. These impacts and expense are not commensurate with the benefit received, resulting in two trends that are having a negative effect on capital formation for small companies in the United States.

Many issuers are choosing to terminate their registration or go dark. Additionally, an increasing number of issuers are choosing to go public in markets outside of the United States. Both of these fall under the "law of unintended consequences," having the effect that this is the exact opposite of what SOX attempts to accomplish. Rather than increasing disclosure and providing stronger controls for companies, many issuers are terminating previously available disclosures, or, by going public elsewhere, not providing them at all.

According to a study at the University of Maryland, approximately 200 companies petitioned to delist their stock in 2003, with an estimated similar number in 2004. This compares with just 67 companies in 2002, prior to the implementation of SOX. Their securities are either moved to the pink sheets where they frequently decline in price, or they stop trading altogether. As the investors are left in the dark, having significantly less knowledge about the actions of management and operational results of the company, they

are left with little leverage with which to form the basis of a more accurate valuation.

The second trend is the growth of competing, non-U.S. marketplaces that cater to small cap companies, particularly the AIM in London. The number of foreign companies listed on the AIM has nearly doubled every year since the year 2003 when SOX was first implemented. With only 60 foreign countries listed on the AIM in 2003, the number jumped to 116 in 2004; 220 in 2005; and 262 through May of this year.

Among it's listed companies, the AIM includes 37 U.S. companies up from 17 1 year ago. Some of these abandon their U.S. trading status in order to join the AIM. Some never pursue U.S. trading at all. Further, emphasizing this attraction is the fact that newer markets are being formulated that are emulating the AIM system, not the NASDAQ. As these alternatives become increasingly available and credible issuers, both United States and international, will have less incentive to face the complexities and costs of trading in comparable U.S. markets.

The two trends presented above reflected the general pushback smaller public companies are having against SOX. While many smaller public companies are choosing to stay the course and comply with the newer regulations as they become applicable to them, there is a significant discontent and concern regarding the disproportionately high cost to them. A study by Foley & Lardner found that in fiscal year 2005, the percentage increase in average audit fees was significantly higher for small cap companies at 22 percent than mid cap at 6 percent and S&P companies at 4 percent. The year-to-year percentage increases were greatest during the phase-in of Section 404 requirements, with the largest increases being felt by small cap companies.

In preparation for this testimony, we surveyed smaller companies to get feedback regarding their experience with SOX. In this informal survey, approximately 70 percent felt that SOX had no effect on communications with shareholders, communications with analysts or other information useful to management. Sixty-seven percent of those surveyed also felt the quality of their financial reporting was the same, although 31 percent did feel that it had improved since the implementation of SOX. Seventy-four percent believed that the results obtained were not worth the expense and effort in implementing them.

As an additional gauge of the perception of the effects of SOX, we surveyed investors, including 27 individuals and institutions. We asked these investors about the effects of SOX on the small and micro cap companies they invest in or would like to invest in. While 33 percent of the group believed SOX had the potential to reduce the risk of management fraud, 56 percent believed it had no effect. Almost the entire group, 93 percent, felt that SOX had a negative effective on issuer profitability, and 100 percent believed SOX has caused small and micro cap companies to be less likely to go public in the United States. When rating the effect of various factors on positive share performance, 85 percent felt that earnings and revenue growth was the most important, while 85 percent felt that compliance with SOX was least important. This indicates that, while investors find there are some positive aspects to SOX, those

aspects are not as highly valued in the marketplace in light of the negative impact it has on profitability.

Thank you very much.

[The prepared statement of Mr. O'Shea follows:]

John P. O'Shea
President & CEO
Westminster Securities Corporation

Testimony
Before the Committee on Government Reforms, Subcommittee on Regulatory Affairs
Unites States House of Representatives

"A Balancing Act: Cost, Compliance, and Competitiveness after Sarbanes-Oxley"
June 19, 2006

I would like to first express my appreciation for the opportunity to speak before the Subcommittee on Regulatory Affairs and share my views with regard to the costs and benefits of Sarbanes-Oxley. This is an issue of great importance to small businesses in America as well as to the financial community, regulators, and others who provide services to this vital segment of the American economy.

I am speaking before the Subcomittee from a dual perspective: first, as President, CEO & owner of an NYSE and NASD member firm that has small business issuers (SBI's) as clients, and secondly, as an individual who has invested personally in many SBI's and has also acted as an officer and director of SBI's.

Unintended Consequences: Decreased Liquidity & Competitiveness of U.S. Markets

I have been working with SBI's for over twenty years, and have witnessed numerous changes in regulations that have significantly improved the transparency of small cap markets, particularly the OTC Bulletin Board (OTCBB). While some of these regulations placed increased burdens on issuers, they were regulations aimed specifically at smaller issuers for the purpose of enhancing disclosure and market liquidity for smaller public companies. By contrast, the Sarbanes-Oxley Act (SOX) has placed a broad-based burden on public company issuers of all shapes, sizes, and characteristics. While there are many positive aspects of the Act, such as those regarding conduct and related-party transactions, the audit and review standards are particularly onerous. In the case of larger companies, I believe the burden can be absorbed with reasonable impact and the benefits are realized by a large number of investors. In the case of smaller public companies, however, I believe the cost, in terms of both financial impact and management resources, has a disproportionately large effect. These impacts and expenses are not commensurate with the benefit received, resulting in two trends that are having a negative effect on capital formation for small companies in the U.S.:

- Many issuers are choosing to terminate their registration, or "go dark"
- An increasing number of issuers are choosing to go public in markets outside the U.S.

Both of these fall under the "law of unintended consequences", having an effect that is the exact opposite of what SOX attempts to accomplish. Rather than increasing disclosure and providing stronger controls for companies, many issuers are terminating previously available disclosures, or, by going public elsewhere, not providing them at all.

According to a study at the University of Maryland, approximately 200 companies petitioned to delist their stock in 2003, with an estimated similar number in 2004. This compares with just 67 companies in 2002, prior to the implementation of SOX. Considering there are approximately 5,000 issuers on the Nasdaq Capital Market, American Stock Exchange (Amex) and OTCBB markets combined, which is where I would assume the brunt of these de-registrations were felt, this implies a loss of about 4% of smaller companies from the public arena per year. I cannot begin to estimate the number of individual investors affected by this, but I expect that the number is vast. Short of taking costly legal action against the issuer and further burdening our court system, investors in such a situation have little recourse. Their securities are either moved to the pink sheets where they frequently trade at a fraction of their prior price, or they stop trading altogether and pricing becomes subject to the whims of a few large shareholders or management who may offer to repurchase their shares at a steep discount. As the investors are left in the dark, having significantly less knowledge about the actions of management and operational results of the company, they are left with little leverage with which to form the basis of a more accurate valuation.

The second trend is the growth of competing, non-U.S. marketplaces catering to small cap companies, particularly the Alternative Investment Market (AIM) in London. The number of foreign companies listed on the AIM has nearly doubled each year since 2003, when SOX was first implemented. With only 60 foreign companies listed on AIM in 2003, the number jumped to 116 in 2004, 220 in 2005, and 262 through May of this year. By contrast, the number of Nasdaq Capital Market issuers has declined by 129 from December 2003 to date, an 18% decline, while OTCBB issuers have declined by 243 (6.8%) over the same time period. The one bright spot is Amex, which gained 159 issuers from December 2003 to date, although this still nets to a loss of 213 across the three markets – nearly identical to the number of foreign issuers on the AIM.

Among its listed companies, the AIM includes 35 U.S. companies, up from 17 one year ago. Some of these abandoned their U.S. trading status in order to join the AIM; some never pursued U.S. trading at all. Our own investment banking clients, including Chinese, Eastern European, and even U.S. issuers, have requested that we consider the AIM as an option for them as an alternative to U.S. markets. In fact, one of our former clients is now listed on the AIM after opting against the U.S. markets. Additionally, our customers that invest in small cap stocks are increasingly trading in non-U.S. markets and expressing interest in making direct investments into companies traded in non-U.S. markets. Further emphasizing this attraction is the fact that newer markets are being formed that are emulating the AIM, rather than Nasdaq. In the past year the Irish Stock Exchange launched the Irish Enterprise Exchange, the European Euronext market launched the Alternext market, and Deutsche Borse launched the Entry Standard market, each focused on small-cap companies. As these alternatives become increasingly available and credible, issuers, both U.S. and international, will have less incentive to face the complexities and costs of trading on comparable U.S. markets.

Costs and Benefits: Perceptions of Issuers and Investors

The two trends presented above reflect the general push back smaller public companies are having against SOX. While many smaller public companies are choosing to stay the course and comply with the newer regulations as they become applicable to them, there is significant discontent and concern regarding the disproportionately high cost to them. A study by Foley & Lardner LLP ("F&L") found that for FY 2005 the percentage increase in average audit fees was significantly higher for small cap (22%) than mid cap (6%) and S&P companies (4%). The year-to-year percentage increases were greatest during phase-in of Section 404 requirements, with the largest increases being felt by small cap companies.

In preparation for this testimony, we surveyed smaller public companies, which I define as companies with market capitalization and revenues below $100 million[1], to get feedback regarding their experience with SOX. Of the 36 responses, the companies had average market capitalization of $28 million and revenues of $22 million and trade primarily on the AMEX, OTCBB, and Pink Sheets. The vast majority of the survey group had not yet implemented Section 404, but expected to do so in the next two years. Of those surveyed, approximately 70% felt that SOX had no effect on communications with shareholders, communications with analysts, or other information useful to management. 67% of those surveyed also felt the quality of their financial reporting was the same, although 31% did feel it had improved since the implementation of SOX. 74% believed that the results obtained were not worth the expense and effort in implementing them. This closely mirrors the 82% of respondents to F&L's study who felt that corporate governance and public disclosure reforms are too strict.

In addition to the direct costs of compliance, many companies felt indirect costs to their overall business. 35% of our survey respondents felt that SOX compliance took management time and attention away from managing their business, while 81% had to hire additional staff or outside consultants to comply with SOX. F&L's study found that 34% of respondents had to make budget and/or staffing cuts in critical areas of their business to accommodate their SOX budget and requirements.

As an additional gauge of perception of the effects of SOX, we surveyed investors, including 27 individual and institutional investors. We asked these investors about the effects of SOX on the small and micro cap companies they invest in or would like to invest in. While 33% of the survey group believed SOX had the potential to reduce the risk of management fraud, 56% believed it had no effect. Almost the entire group, 93%, felt that SOX had a negative effect on issuer profitability, and 100% believed SOX has caused small and micro cap companies to be less likely to go public in US markets. When rating the effect of various factors on positive share price performance, 85% felt earnings and revenue growth was most important, while 85% felt compliance with SOX was least important. This indicates that, while investors find there are some positive aspects to SOX, these aspects are not as highly valued in the marketplace in light of the negative impact on profitability.

[1] While Small Business Issuers are currently defined by the SEC as companies with less than $25 million in annual revenues, I believe this number is out of date given the effects of inflation, the general increase in market valuations over the years, as well as the increased costs of being a public company as a result of SOX, which represent significant costs to companies much larger than the $25 million current standard.

The Impact of Section 404

It is certainly well documented that Section 404 has been the most contentious aspect of SOX. As I stated earlier, I do believe SOX has many positive aspects, including the formation of the PCAOB, increased auditor independence and more direct corporate responsibility on executive officers and directors. Additionally, many of the financial disclosures required by Section IV of the Act, such as greater disclosure of related party transactions and more frequent SEC review of periodic disclosure reports, greatly enhance investor protection in the U.S. However, Section 404 specifically is counterproductive in two ways:

- Taking management time and attention away from managing its business
- Creating a contentious relationship between management and outside auditors

Under Section 302 of SOX, each issuer's principal executive officer and principal financial officer takes responsibility for the contents of every periodic report filed by that issuer, including the financial statements and internal controls. As a result of this section, it is of course in the best interests of such officers to implement appropriate controls to ensure their results of operations are properly recorded and reported. Each of these officers are intimately familiar with the workings of their own business, and therefore are in the best position to evaluate whether their controls are appropriate. Under Section 404, these officers would be required to spend significant time explaining their procedures to an outside auditor with limited knowledge of their business, and be forced to defend them against as yet undefined standards of effectiveness. This time could be much better spent on the implementation, rather than explanation, of these procedures, as well as nurturing suitable growth for the company within the boundaries of the procedures.

The auditor's limited knowledge of an issuer's business further makes Section 404 a very risky proposition for the auditor. While an auditor's role is key in advising a company with respect to the proper preparation of financial statements, application of financial guidelines, and disclosures with respect to financial statements, the evaluation of internal controls is an area outside of an auditor's training. The U.S. is a wonderful economy, nurturing of companies of all shapes and sizes. Consequently, entrepreneurs have developed countless different methods of managing their companies in a method that is appropriate for their organization. Some companies believe in a more centralized management system, others more decentralized, while others defy definition. The internal controls appropriate to an organization derive directly from their management style – whether they want each accountant to report directly to the CEO, assign a team leader to groups of employees, or create a chain of command through 5 departments. To ask an outside auditor to evaluate a company's internal controls is to ask them to evaluate that company's business culture and structure. Given that there are no by-the-book ways to test this, auditors are being given a nearly impossible task, which can easily result in disagreements with management, thereby impeding upon the auditors' most significant task – the audit of financial statements.

Conclusion

I suggest to the Committee that the benefits SOX intended to bring to America's capital markets are greatly weakened or even removed by the migration of small companies away from U.S. public markets. For those companies that remain, the increased costs and management time associated with some of the more onerous provisions of the Act, particularly Section 404, have had a negative effect on financial and operational performance, making these companies less competitive in the global marketplace.

SBI's are the companies with the greatest potential for growth, that create the most jobs and fuel our economy. While there are risks and failures among them, they also offer the highest returns over time, and they often grow into larger cap companies or become acquired by larger cap companies, thereby fueling additional growth. If we do not nurture our SBI's during their incubation period, we will continue to lose our unique level of innovation to markets outside of our borders.

Closing Remarks

In closing, I continue to believe that the U.S. has the best, most transparent markets in the world. That said, I believe we need to repair some of the stigma that foreign issuers in particular have against SOX by showing our willingness to adopt standards that are appropriate for different types of issuers. In view of the benefits that small businesses bring to America and its financial markets, Congress and the SEC should find ways to stem the tide of companies away from U.S. public markets without losing the investor protection these markets confer. While I understand that these are complex matters which should not be entered into lightly, I believe it is essential that necessary changes be adopted quickly in order to remove the uncertainty that currently hangs over our small cap markets.

Thank you again for the opportunity to express my views.

Mr. MCHENRY. Thank you, sir.
Mr. Lawrence.

STATEMENT OF DAVID LAWRENCE

Mr. LAWRENCE. Thank you for providing the opportunity to testify before you today on Sarbanes-Oxley Act, Section 404, and finding the proper balance among cost burdens, investor protection and U.S. competitiveness.

I currently serve as the chief financial officer of Acorda Therapeutics. We are a public biotechnology company located in Hawthorne, NY. I have been involved with the management of corporate governance and finances in biotech and high tech companies for over 15 years. Founded in 1995, Acorda is a biotechnology company focusing on the development of next generation therapies that restore neurological function to people with spinal cord injury, multiple sclerosis and related conditions of the nervous system.

Our company has clinical and pre-clinical drug candidates for MS, the focus on novel approaches to repairing damaged components of the central nervous system. We are currently a net loss company with one drug on the market. Our market cap of approximately $76 million as of June of this year is at the bottom 0.5 percent of total U.S. market cap.

We completed our initial public offering in February 2006 and are currently beginning the process of complying with the Sarbanes-Oxley Act.

Today, I'm here to testify on behalf of the biotechnology industry organization, an organization representing more than 1,100 biotech companies, academic institutions, State bio technology centers and related organizations in 50 U.S. States and 31 nations. The majority of bio member companies are small, research and development-oriented companies pursuing innovations that have the potential to improve human health, expand our food supply and provide new sources of energy.

Acorda Therapeutics has a profile that's typical of the high-risk, capital-intensive, long-lead time regulated business environment of the biotech industry. As a representative of one of the most innovative high growth sectors of our Nation's economy, one in which the United States maintains a global leadership position, my testimony is tailored to the issues faced currently or that will be faced by emerging companies in the biotech sector.

Let me start by saying that we fully appreciate and agree with the congressional intent behind Section 404, ensuring that companies have in place effective procedures and controls to enhance investor protection and protect against fraud. Where Section 404 has gone awry is in the implementation. The current implementation of Section 404 is not tailored and does not work well for small public companies.

The one size fits all approach of Section 404 is highly burdensome and smaller companies are bearing disproportionate costs on a relative basis. This has been recognized and documented, not only by the SEC advisory committee for smaller public companies, where members voted 18 to 3 in favor of Section 404 reform, but also by the GAO, where it found that smaller companies at the bottom 6 percent of total U.S. market cap pay up to $1.4 million on

external auditors for Section 404 compliance. The GAO also found that 47 percent of the companies reported significant opportunity costs related to Section 404, draining resources away from innovation and research.

Even the SEC recognized in its recent statement that Section 404 might need reform based on a top down risk-based and scaled approach, which would make Section 404 more responsive to the individual size and complexity of the companies. For most biotech companies, the cost burdens associated with Section 404 compliance include both internal costs, as well as external auditor costs and are substantial. Our experience as a newly public, non-accelerated company is very similar to those experienced by BIO members. Due to limited internal resources, we will have to immediately contract with an outside consulting firm in order to comply with SOX requirements by the 2007 deadline.

For many of the newly public companies, Section 404 costs could mean having to spend a large portion of their research funding for a leading drug or therapy on Section 404 compliance, forcing many of the companies to make reductions in research spending in order to meet the requirements imposed by Section 404.

For the investors, their confidence and trust in public companies may have increased as a result of SOX as a whole, but not necessarily due to Section 404. As we saw in the first and second years of Section 404 implementation, investors were less concerned when a company reported a material weakness in internal controls under Section 404, than on how much a small company was paying to meet Section 404 requirements.

Here, the cost of implementing Section 404, particularly for smaller public companies, appear to outweigh many of the benefits that are directly related to Section 404.

As embraced by the Advisory Committee in its final recommendations, it is critical that Section 404 reform framework establishing a risk-based approach that provides scaled reforms based on a revenue filter condition. This approach recognizes that level of risk, the level of complexity, and the level of product revenues are clearly interrelated and that product revenue should drive the level of internal control procedures.

Without Section 404 reform, evidence points to the fact that innovation may be stifled and U.S. competitiveness compromised. With recent submission of the Advisory Committee's final recommendations and the SEC's statement of intent for reform, it appears that now is the opportune time for the SEC to fully engage and follow through with reforms consistent with the original principles upon which SOX was enacted.

Thank you for your time and consideration of BIO's views. BIO urges the subcommittee to request expeditious action by the Commission on the reform framework endorsed by the Advisory Committee.

[The prepared statement of Mr. Lawrence follows:]

BIOTECHNOLOGY INDUSTRY ORGANIZATION

ACORDA THERAPEUTICS

Hearing Testimony
David Lawrence
Chief Financial Officer
Acorda Therapeutics, Inc.

On Behalf Of
The Biotechnology Industry Organization

Before the Government Reform Subcommittee on Regulatory Affairs
U.S. House of Representatives
Field Hearing

"A Balancing Act: Cost, Compliance, and Competitiveness after Sarbanes Oxley"

June 19, 2006

Chairwoman Miller, Ranking Member Lynch, and the Members of the Government Reform Subcommittee on Regulatory Affairs:

Thank you for providing the opportunity to testify before you today on Sarbanes-Oxley Act (SOX) Section 404 and finding the proper balance among cost burdens, investor protection and U.S. competitiveness.

My name is David Lawrence, Chief Financial Officer of Acorda Therapeutics, a public biotechnology company in Hawthorne, New York. I have been involved with the management of corporate governance and finances in biotech and high-tech companies for over 15 years. Founded in 1995, Acorda is a biotechnology company focusing on the development of next generation therapies that restore neurological function to people with spinal cord injury (SCI), multiple sclerosis (MS) and related conditions of the nervous system. Acorda's products, Zanaflex Capsules™ and Zanaflex® tablets, are FDA-approved for the management of spasticity, a symptom of conditions such as MS and SCI that is commonly characterized by stiffness or rigidity, restriction of movement and painful muscle spasms. Our Company has clinical and pre-clinical drug candidates for MS that focus on novel approaches to repairing damaged components of the central nervous systems. We are currently a net loss company with one drug on the market and our market capitalization is at the bottom 0.5% of total U.S. market capitalization of $76 million as of June, 2006. We have completed our initial public offering in February, 2006, and are currently beginning the process of complying with the Sarbanes-Oxley Act.

Today, I am here to testify on behalf of the Biotechnology Industry Organization (BIO), an organization representing more than 1,100 biotechnology companies, academic institutions, state biotechnology centers and related organizations in 50 U.S. states and 31 other nations. BIO members are involved in the research and development of health care, agricultural, industrial, and environmental biotechnology products. The majority of BIO member companies are small, research and development oriented companies pursuing innovations that have the potential to improve human health, expand our food supply, and provide new sources of energy. My Company has a profile that is typical of the high-risk, capital-intensive, long lead-time, regulated business environment of the biotech industry.

As a representative of one of the most innovative high growth sectors of our nation's economy -- one in which the United States maintains a global leadership position—my testimony is tailored to the issues faced currently, or that will be faced, by emerging companies in the biotech sector – the microcap and smallcap companies who are among the driving forces of our country's innovation leadership and competitiveness in the global market place.

One Size Does Not Fit All

Let me start by saying that we fully appreciate and agree with the Congressional intent behind Section 404 – to enhance investor protection and confidence. BIO members strongly support this goal. In fact, it should be the goal of all public companies – small or large – to operate in a way that is transparent, is subject to high standards of corporate governance, and enhances investor and shareholder confidence. The vast majority of public companies of all sizes has done so, and continues to do so today.

Where Section 404 has gone awry is in the implementation of the requirements. The current implementation of Section 404 is not tailored, and does not work well, for smaller public companies. The one-size-fits-all approach of Section 404 is highly burdensome to smaller companies, and such companies are bearing disproportionate costs on a relative basis. This has been recognized, and documented, by the SEC Advisory Committee for Smaller Public Companies (Advisory Committee), who voted overwhelming in favor of reform by an 18-3 vote in April, 2006. In its Final Report, the Advisory Committee found that, "with more limited resources, fewer internal personnel and less revenue with which to offset both implementation costs and the disproportionate fixed costs of Section 404 compliance, [small] companies have been disproportionately subject to the burdens associated with Section 404 compliance."

The U.S. Government Accountability Office (GAO) also made similar findings in its May, 2006, report stating that smaller public companies at the bottom 6% of total U.S. market capitalization pay up to $1.4 million on external auditors for Section 404 compliance. In fact, 47% of the companies reported that Section 404 compliance resulted in significant "opportunity costs" by draining resources away from innovation and research.

Even the SEC recognizes that Section 404 needs reform, based on its recent May roundtable discussions regarding Section 404 year two compliance. In fact, the SEC announced in May regarding its intention to review current Section 404 requirements and to provide necessary reforms based on a top-down, risk-based, and scaled approach, which would be more responsive to the individual size and complexity of the companies.

There is agreement among the SEC, its Advisory Committee, and the GAO that Section 404, as currently implemented, fails to scale regulatory burdens on a cost-benefit basis and disregards the levels of product revenues and the complexity of corporate structures, which drive the need for corresponding levels of internal controls.

Simply put, if the current Section 404 implementation continues to be imposed, or, in the case of non-accelerated filers, is imposed in the future, microcap and smallcap companies in our industry will be required to implement internal processes and organizational changes that are completely contrary to the rapidly changing and highly-competitive markets in which we operate.

The Costs of the One-Size-Fits-All Approach to the Industry and U.S. Competitiveness

For most biotechnology companies, the actual costs of Section 404 compliance, including both internal costs as well as external auditor costs, are substantial. In fact, the opportunity costs of Section 404 for smaller companies can be even greater, impeding the ability to invest in and sometimes, to continue ongoing, critical research and development activities. Biotech companies are at the forefront of developing new treatments for many diseases, and biotech companies presently are engaged in over 350 clinical trials for over 200 diseases, from cancer to multiple sclerosis.

Under the requirements of Section 404, significant time and money are spent to put in place complex systems and processes dictated by the Auditing Standard No. 2 (AS2) and required by external auditors. If the current system is not changed, these effects will also be felt by non-accelerated filers as they prepare for compliance by the end of next year, as well as private companies preparing for an initial public offering of their stock.

As a specific example, one of BIO's member companies had five employees working on Section 404 compliance at a cost of approximately $1 million per year. This company estimated that its controller spent approximately 35% of his time on Section 404, while the CFO spent approximately 20% of his time. To complete the mandated internal control processes and the "checklist" dictated by AS2, the company had to increase its accounting staff by 40%. Further, this company reports only a 7% decrease in costs in year two as compared to its first year of compliance.

Another member company's experience shows the opportunity costs of Section 404 compliance. This company not only spent approximately $500,000 on its external attestation of internal controls but also had to endure additional costs in terms of (i) the reassignment of laboratory research personnel to perform internal control work dictated by AS2 and the company's external auditors, (ii) the postponement of the hiring of 5-10

additional researchers, and (iii) the delay of promising R&D programs. Such diversion of resources away from research activities can delay critical product development and has, in turn, a detrimental effect on a company's ability to raise capital.

Our experience, as a newly public company is very similar to those experienced by BIO member companies. Due to limited internal resources, we will have to immediately contract with an outside consulting firm in order to comply with SOX requirements by the 2007 deadline. We will be facing the same SOX related expenses similar to that of other biotech companies. For many of the newly public companies, Section 404 costs could mean having to spend a large portion of their research funding for a leading drug or therapy on Section 404 compliance -- forcing many of the companies to make reductions in research spending in order to meet the regulatory requirements imposed by Section 404.

It is also the experience of BIO members that the current problems with Section 404 are not merely growing pains where the costs and burdens will decrease once the auditors and companies become more familiar with the process and requirements. The current implementation of Section 404 imposes the same requirements, steps and reviews on all companies, by the same individuals year after year. As a result, the costs are fixed and ongoing, impacting the long-term investment resources of microcap and smallcap companies.

For the investors, their confidence and trust in public companies may have increased as a result of the passage of SOX as a whole and not necessarily due to Section 404. The other provisions in SOX include whistleblower protections, increased enforcement powers, such as the SEC's increased ability to obtain officer and director bars, auditor independence requirements and, perhaps most importantly, CEO and CFO certifications of company financial statements under section 302 of SOX. As we saw in the first and second years of Section 404 implementation, investors and the market generally had little market reaction when a company reported a "material weakness" in internal controls under Section 404.[1] As we discussed further above, the costs of the implementation of Section 404, particularly for smaller public companies, appear to outweigh many of the benefits that are directly related to Section 404.

The impact of Section 404 costs on the U.S. economy and our industry's competitiveness abroad is also of great concern. As many Members on the Subcommittee may have undoubtedly heard and read, there is evidence that foreign firms, the largest of which will be subject to Section 404 compliance beginning July 15, 2006, are foregoing the U.S. markets and listing overseas due, in large part, to Section 404, not necessarily because of SOX in general. In fact, the SEC Commissioner Atkins in his letter to the Wall Street Journal on June 10, 2006, indicated that last year, nine out of every ten dollars raised by non-U.S. companies through new stock offerings were issued overseas, while the reverse was true just six years ago in 2000. In addition, it is the experience of BIO's private

[1] See, e.g., Neil O'Hara, An Analysis of the (Non) Impact of SOX 404, Compliance Week, March 8, 2005. In addition, at the 2005 SEC and PCAOB Roundtable on Section 404, a representative of Moody's on one of the panels stated that, of the 71 companies disclosing material weaknesses they considered in detail, they ultimately issued a negative rating action on 12, or 20%, of the companies. Thus, credit rating agencies had no adverse reaction to approximately 80% of the companies.

company members that an initial public offering is becoming less and less the optimum path to liquidity for their investors due to the timing issues associated with accessing the market while at the same time ensuring readiness for Section 404. This issue has been previously noted by the recently-appointed head of the Division of Corporation Finance at the SEC.[2]

Scaled Reform Needed for Smaller Public Companies

As embraced by the Advisory Committee in its final recommendations, it is critical that the Section 404 reform framework establishes a risk-based approach that provides scaled reforms based on a "revenue filter" condition. This approach recognizes that the level of risk and the level of product revenues are clearly interrelated and that the level of product revenues should drive the complexity of internal control procedures. An approach that scales Section 404 requirements based on the level of product revenues also provides a risk-based approach, more appropriate for microcap and smallcap companies in our industry. Biotechnology start-up companies early in their histories often have very limited product revenues compared to their market capitalizations. For example, it is not uncommon for a public biotechnology company to have a market capitalization of $700 million or greater with product revenues of $1 million, or less.

BIO has urged the Securities and Exchange Commission (Commission) and the Public Company Accounting Oversight Board (PCAOB) to, as expeditiously as possible, take the necessary steps to adopt the following reform framework as endorsed by the Advisory Committee:

- Section 404 requirements should be "scaled" and "proportional" to the size of product revenues and complexity of corporate structures.

- Scaled reform should be based on the principle that the level of risk and product revenues are intricately tied, that product revenues drive the complexity of corporate structures and the corresponding need for more rigid and established internal control processes.

- Product revenue should be defined as product and services revenue, excluding revenues from license fees, research and development payments, milestone payments, and other payments received from an unrelated third party before product sales have commenced under the terms of a collaborative contractual agreement to develop a product.

- The internal controls necessary to meet Section 404 should be consistent with the level necessary to meet the CEO and CFO certifications of company financials as currently required under Section 302 of the Sarbanes-Oxley Act.

[2] See, the letter from John W. White, the new and current head of the Division of Corporation Finance at the SEC, submitted in connection with the SEC's 2005 Roundtable on Section 404, available at http://www.sec.gov/news/press/4-497.shtml.

The proposed reform framework supports the management's incentive to maintain effective and integrated systems of internal controls and produce accurate financial reports, most important to the investors. Section 13(b)(2)(B) of the Exchange Act requires, as it has since 1977, that public companies maintain a system of internal controls that provide reasonable assurances as to the accuracy of financial reports. This framework provides additional assurance to investors in a cost effective and risk based way to providing Section 404 relief for smaller public companies. Under SOX Section 302, each CEO and CFO must certify that the financial statements fairly present in all material respects the financial condition of the company, and they have disclosed all weaknesses in the internal controls which could be reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information, among other items.

As demonstrated above, without Section 404 reform, evidence points to the fact that innovation may be stifled and U.S. competitiveness compromised. With the recent submission of the Advisory Committee's final reform recommendations in April, and the SEC's announcement in May regarding its intention to take additional steps to reform Section 404, it appears that now is the opportune time for the SEC to fully engage and follow through with reforms consistent with the original principles upon which SOX was enacted.

Thank you for your time and consideration of BIO's views. BIO urges the Subcommittee to request expeditious action by the Commission on the reform framework endorsed by the Advisory Committee. These reforms are critical in providing the high growth sectors of the U.S. economy with the continued opportunity to lead, innovate, and compete in the global market place.

Mr. McHENRY. Thank you, sir, and I'll begin the questioning. We'll start the clock with 5 minutes.

Mr. Robotti, a question for you. How much do you rely on Section 404, in terms of making decisions about companies? What is your reliance on Section 404?

Mr. ROBOTTI. Well, one of the points I raised is that I don't think the public market really ascribes much value to it because if you look at the micro cap companies that are not accelerated filers, less than $75 million of unaffiliated market cap today, there's no repricing of the securities in those markets. They don't have a higher multiple, but you've got to pay for those stocks. They don't sell a higher multiple, a lower multiple for books. So it doesn't seem to me, because part of the portfolio companies that we invest in are still not 404 compliant and others are. So you know, I, as an investor, look at these companies, have met with managements, look at the financial reports they have, look at what they've done in the past in terms of restating their financials, and make my own subtle assessments about the reliability of management and internal controls. And so it's really not an assessment, because from the outset, it's, of course, always difficult to understand exactly the process that they went through in 404.

The companies that I am familiar with the 404 processes that they have gone through, you know there are some benefits that do come from kind of reviewing top down, everything they do, but the time and effort involved—there's a lot more detail work that really is relatively irrelevant. So that's my opinion. And I clearly have talked to companies who have said, listen, who have said to me, the cost of being a public company is not that significant, so I don't know why company XYZ who is a competitor of ours did deregister—this is 2 or 3 years ago—for other reasons. And then I come back to them a couple of months later and they say gee, we've looked at this 404 and we're looking at what the time and effort is going to be involved and the cost of it. I'm considering that we would really deregister.

So that's a specific company where I've had conversation where clearly the guy said it's not significant being a public company and the costs aren't that significant to evaluating 404 and saying: "I don't know if I really want to go through that process and incur all these incremental expenses and I don't really see the benefit added." And I could understand, yeah, I own 19 percent of the company and yet I'm not really an insider. I'm not really privy to any information that any outside investor isn't, but I understand his process. And if I were a director, I would think yeah, maybe that is really relevant for you to not be a reporting company.

Mr. McHENRY. All right, I think it's pretty clear we understand the problems in the marketplace and I appreciate you touching on that. Now if we could transition, if we all, all four of you could take just 30 seconds and explain what we should do, what Congress should do, what action we should take and we'll begin with you, Mr. Robotti, but please keep it at 30 seconds. We've got to keep to the time.

Mr. ROBOTTI. 404 is extremely poorly designed and implemented. The idea that you need additional work done on internal controls is logical and in the testimony given by an ex-SEC Commissioner

who said what you've got to do, he said take 1 day for the CFO, 5 days for the order and that's what he said he designed the law when he implemented the law and wrote the law and that's not what's happening. So the implementation is vastly off.

Internal controls are good. You need it. 404, way overkill.

Mr. MCHENRY. Mr. Beach.

Mr. BEACH. I'm not on the market, so I won't give you that kind of a detailed response, but let me just say that I think you should commission research on the economic effects of 168 words. I honestly think that Congress needs to have more information and reliable peer-reviewed information about what this has done, so you can get past the anecdotes which are all very important and into something that's more solid than that, something that you can rely on.

Mr. MCHENRY. Mr. O'Shea.

Mr. O'SHEA. At the very least, I think you should delay implementing some of the more onerous provisions of the act, particularly 404, to do cost benefit studies, to understand the effect and perhaps consider having some companies, small cap companies or different industries being exempt from those provisions.

Mr. MCHENRY. Mr. Lawrence.

Mr. LAWRENCE. Similar. It's the 404 provisions that are especially difficult for small companies such as Acorda and others in the biotech industry. It really is either—put on hold so it can be further studied and analyzed or some sort of a leveled approach or scaled approach based on revenue and market cap.

Mr. MCHENRY. All right, I appreciate your input.

Mr. Dent.

Mr. DENT. Thank you, Mr. Chairman. Mr. Beach, I do appreciate your comment just a moment ago about the impact of 168 words on the economy. And I'm always reminded in this business of legislating that we pass laws to stop people, bad people from doing bad things and the corollary to that is oftentimes it prevents good people from doing good things and I think you drove that point home.

Mr. Lawrence, I represent an area of the country where there's a lot of biotech interest and activity. And I'd be curious to know have you, are you aware of any research that has been foregone or discoveries that are not being made because of the compliance costs associated with Section 404?

Mr. LAWRENCE. It's tough to say what discoveries have not been made, if the funds haven't been directed toward them. In our case, we will probably be similar to other biotech companies where you could spend upwards of $1 million or more in the implementation of SOX, so for a small company like us, that's $1 million that will not be used to bring in more researchers and license additional technology or things that could accelerate the development of breakthrough drug in the future.

Mr. DENT. With respect to these opportunity costs for these small companies, I mean just elaborate on that. What do these opportunity costs—what opportunities are being missed?

Mr. LAWRENCE. Just the opportunity to—you may have drugs reaching a certain development stage where additional funding could take it to the next level. Get it into a clinical trial, bring it into a Phase 2 clinical trial. Get it out of the laboratory and into

human testing. Those are questions that you will ask yourself, if you're spending money on things that are not going to the research and development, primarily what investors have invested in our company for.

Mr. DENT. Mr. Beach, can you just elaborate too on the impact on jobs. We're always talking about jobs around here and what do you see the impact on jobs because of this statute, Sarbanes-Oxley, and its implementation, I should say?

Mr. BEACH. Well, our own research is beginning to indicate pretty strongly, Congressman, that Sarbanes-Oxley has, in fact, added to the cost of capital and we know that in looking at large models of the U.S. economy, as well as industry specific models, that capital costs are really the big driver in business expansion, in reinvestment and new technology, all of which has immediately two areas, one, and that is the improvement in salaries and wages. It makes workers more productive and they're able to command higher pay and so if capital costs are going up, that will reduce the potential wages and salaries and also in achieving new employment. And when Congress acts to increase the cost of capital, that is worse than when any other institution in the United States acts, for example, just capital market increases because people who are borrowing now have to also calculate that you will followup this action with other deleterious actions and so we say in our modeling that at one-tenth of an increase in capital costs that's due to your actions results in 100,000 lost potential jobs, not actual jobs, but potential employment falls by that amount.

Mr. DENT. And what industries do you think, looking forward, will be most impacted by this law, knowing that $9 out of $10 raised for these new companies are being listed elsewhere, outside of this country?

Mr. BEACH. That's why I think our research in the venture capital data was so important and revealing, Congressman. And just very, very quickly, we saw a real movement away from companies that would have difficult decisionmaking by the private boards. An unwillingness to take a company public, in other words. High technology companies. Of course, the area of the economy which has been benefited by Sarbanes-Oxley was made in the previous panel. We saw an increase, not only in compensation, but in numbers in the financial services sector, but particularly accountants and those subsectors. That's what the research indicates at this particular point.

Mr. DENT. Thank you, Mr. Chairman. I will yield back.

Mr. MCHENRY. Ms. Kelly.

Ms. KELLY. Thank you. I'd like to ask Mr. Lawrence, biotech companies have really very low product revenues comparable to their market capitalization. And it's not uncommon for a newly public biotech company to have a market capitalization of $700 million, but have product revenues of less than $1 million.

The SEC Advisory Committee for Smaller Public Companies defines a smaller public company in terms of revenue and market capitalization. Now I asked the prior panel, is that an appropriate way to define or should we do it only on market capitalization alone? Should we—how do we redefine that so that it makes some sense?

Mr. LAWRENCE. The market cap is an important piece. The revenue portion and it is true that when a company begins to have revenue, it does create more complex financial statements. Case in point, we recently went public and we acquired a product last year in 2004 and there was a large amount of work that went into revenue recognition on this product and how to report it on the books. Very detailed, very—intricate accounting policies had to be followed.

So I think that the revenue piece is an important piece because it does add a sense of complexity to the financial statements and creates another layer of potential accounting discrepancies.

Ms. KELLY. Let me ask another question. I've been sitting here thinking, listening. Are we holding the companies liable for something that we ought to perhaps because we're talking in Section 404 about figures that the accountants have? Perhaps we should talk about where the accountants are being held because when an accountant goes into a firm, the only way they're going to get any information about the firm really is if they've been doing it repeatedly and they know the firm very well or whatever the firm tells them, that's what they get.

Should we perhaps be looking at accountancy, along with what we're talking about with trying to get some—the whole basis for 404 was transparency and the whole idea for transparency was to get some honesty out there in the marketplace to help an investor be able to invest with all of the available information. But perhaps there should be something we should be looking at in terms of accountancy with relationship to what this Section 404 is demanding of companies. I'm asking this of all of the panel.

I'd like to start with you, Mr. Robotti. Have you thought about that? And I'd like to hear your thoughts.

Mr. ROBOTTI. Accounts play a key role in the total equation here and of course, they're driving—I think that's one of the problems with 404 is of course, you know their interpretation of PCAOB rules are how do you do an internal 404 review is what's adding to costs because that's one of the recommendations, of course, the committee did make that for small companies, not micro companies, so therefore between $700 million and market cap and over $128 million, that qualification would move over time because it's as small as 1 percent. Those companies would be exempt from the external auditor opinion on Section 404.

My personal experience with one company where I am director today and on the audit committee, we just the other day met and our internal, our external audit was $100,000 incremental the first year and we paid $100,000 to hire a consultant to work with us to implement 404 and to put in internal controls and of course, there's the time and effort internally.

The second year, the auditors charging us the same $100,000 to do the audit, no cost savings the second year. There was a 100-hour reduction from 580 to 480, but they raised the rates. So it's the same price. The external consultant went from $100,000 to $30,000 the second year. The external consultant clearly was important helping the company organize, demonstrate and categorize all of the internal controls that happen and put in controls that needed to be done the second year, but became more efficient. The external

auditor, I don't know what they did the first year other than act as the oversight person to make sure that the internal work was done. The second year, I don't know what they're doing because I just don't understand that process. So that's what I'm saying, the implementation of 404, I think is a problem. I think auditors are a key part of the problem.

An extra reason why you don't need 404 today, the auditors kind of run the show because if they say listen, we don't like the data you gave us, then you know, we're going to say you've got to give us more data and more information. They control that relationship today.

Ms. KELLY. Well, should there be some liability there? I don't know——

Mr. ROBOTTI. There is liability. They're concerned about liability. It's what's causing them to over-implement, over-design 404. That's what's driving that.

Mr. BEACH. Congresswoman, I just wanted to say that I think you're on to something important there and we've noticed it too. This is not only an intervention into the financial side of private businesses and publicly traded companies and so forth, but the accounting industry should be in—it should be something that you should be concerned about because it was an intervention in their industry.

Good accountancy leads to good information, leads to good pricing of companies, leads to a good allocation of resources in the economy. So I think accountants are absolutely critical to all of this and if we have damaged that industry inadvertently, we need to now pay a lot of attention to the rectification of that industry.

Ms. KELLY. Mr. O'Shea.

Mr. O'SHEA. 404, in my view, has cause for two things to reinforce what Bob said. It could cause for very tough relationships between the auditors and the issuers because the auditors are constantly looking over their shoulder and the costs, both in monetary and running of the business by the issuers has gone up dramatically.

Additionally, 404 causes the auditors to have to learn a lot more about the businesses than they've ever had to in the past. They should really be focused on their job which is analyzing the financial statements.

Mr. LAWRENCE. I think that some additional clarity around exactly what the auditing firms need to be doing, separate and apart from a financial audit is part of the problem. I'm not sure they understand, speaking of liability, where it ends and where they're off the hook and where they're not and what they need to do and what they don't need to do. So that's part of the problem. So basically what they're doing is looking at everything.

Ms. KELLY. Thank you.

Mr. MCHENRY. Thank you, Ms. Kelly.

Mr. Feeney.

Mr. FEENEY. Well, thank you, Mr. Chairman, and in fairness, somebody has to speak up for the accountants here. They're not here to defend themselves. To the extent the Big Four were endowed by Congress, intentionally or unintentionally, with control of the marketplace, Pepsi needs an internal auditor and an external

auditor. Assuming they don't want to hire the same two that Coke has already signed up, we have created this monopoly rent-seeking opportunity and I don't particularly blame the accountants for taking advantage of something that we in the SEC and PCAOB have endowed them with. I do think that it's one of the problems we haven't talked about here today, but that's probably best talked about when we have some folks from the accounting industry, both big firms and small firms.

Mr. Robotti, you control about $300 million of investment, your firm does. Do you, as part of your due diligence, when you make an investment decision, do you go down and pull a 404 report and pour over the pages 1 through 480 or whatever?

Mr. ROBOTTI. There is no external—404 is just a sentence. There's no detail, no information.

Mr. FEENEY. OK, but the compilation of that report by the external, I mean there is a report that the external auditors do, is there not?

Mr. ROBOTTI. No.

Mr. FEENEY. Well——

Mr. ROBOTTI. There is no outward available public dissemination of information that is the culmination of the 404 report, other than the opinion of the auditor.

Mr. FEENEY. OK, Mr. Robotti, you indicated in your testimony that you think that small companies, given the—they were bumping up against this December 16th date and even some companies that have complied, I think the way you put it was that they have a duty to consider going—a duty to their investors, a duty to consider going dark. Does that also include maybe a duty to consider going offshore with respect to where they list and whether or not they delist? I mean Mr. Coulson has a proposal he refers to as DOD that's sort of a private regulatory proposal.

Mr. ROBOTTI. I think all of those things potentially make sense. I can see where it is logical for a board of directors to decide to register as a public company to trade in the pink sheets. The problem with that is that decision is unilaterally in the decisions of the board of directors, what to do, and then once that's happened how does that company act and how does it treat those shareholders who potentially are disenfranchised because instead of having all of the disclosures and the protections and of course, that's what it is. It's the disclosure of information that potentially provides investors with the ability to understand that something is going wrong and if we were to seek some kind of redress whether that's to change the board, whether it's court action, if you don't have the information, you can't do that and that is unilaterally decided by the management in the board today. That's the problem with the process.

Mr. FEENEY. I don't know whether you've read Mr. Coulson's testimony, but he's got a private regulatory proposal he thinks takes care of some of those.

Mr. ROBOTTI. But that's a voluntary, on the part of the company process. I, as a shareholder, really have no say in whether that company—I have a company that just last week announced that it's going to deregister with the SEC. IT's an ex-New York Stock

Exchange company. It will do $700 to $800 in revenue and I don't know what they're going to do tomorrow.

Mr. FEENEY. That's true, that's a problem. But as an investor going forward, you have a choice when you're choosing where to put your money, company A or B, to determine whether or not the private regulatory scheme or 404 compliance is a better place.

Mr. ROBOTTI. But I disagree with the fundamental, that concept. You are forgetting about every shareholder of those companies that currently had invested, when they were a reporting company, when they took on that obligation. Now suddenly, they're not any more. It's not my new investment of capital. It's not the new creation of company giving capital, that's a problem, but you've forgotten about the guy who was a shareholder who bought in under a presumption that——

Mr. FEENEY. I couldn't agree with you more. We don't have any argument at all. It's one of the unintended perverse consequences of the way we've implemented Section 404.

Mr. Beach, you're not an economist, you're a data analyst, is that right?

Mr. BEACH. I am an economist, sir.

Mr. FEENEY. You are an economist.

Mr. BEACH. With due apologies.

Mr. FEENEY. I'll ask you your opinion on a big question and ask you whether or not we can ever quantify it because you have some obvious expertise in the quantification and the scientific approach.

I want to know your opinion whether the cost of SOX compliance has resulted in the loss of more jobs and the more net value to the American economy than Enron and World Com combined, and then I want to know because your methodology, as I understood it, is you're going to look at the companies that have basically gone dark or delisted or are availing themselves of private equity markets where they would have probably stayed in the public equity markets. Then you're going to look at the inefficiencies and the cost of raising capital and you're going to give us a number.

That method seems to me woefully inadequate to talk about the total impact on the economy, because Mr. Lawrence just explained that he's got his best and brightest scientists, in some cases, spending a good portion of their time instead of finding the next cure for multiple sclerosis, they're talking to their internal accountants, their external accountants, their lawyers and others. So it's almost impossible to quantify the loss of opportunity, isn't it and I'll let you answer those questions.

Mr. BEACH. With any precision, it certainly is. What we try to do in this particular case is go through the following exercise. We're taking a lot at what we think is a leading industry in this whole debate and that is the venture capital industry. That's just one of many and we are saying can we isolate the effects of changes in that industry due to Sarb-Ox on the cost of capital and several other, Congressman, economic concepts. If we can, then I can take those results and move them into another model of the U.S. economy which has been used for a long, long time by economists, a very good detailed model, in fact, I imagine you even used it.

And from there, we can then say this is the effect of Sarb-Ox on the economy. Same exercise. Look at Enron, World Com, Global Crossing. Did they have that kind of tangible effect on these key economic drivers? Move those results into the same model and then compare the effects of these companies having that increase in cost of capital as opposed to Sarb-Ox. That is exactly what we're doing right now in my unit.

It's a real good economics question. It's a real good data analyst question and we will reach a conclusion contrary to the old saying that if you lay all economists end to end, they never, in fact, reach a conclusion. I think we're very close to being able to advise the committee that Sarb-Ox has a long-reaching and very deep effect on the economy.

Mr. McHenry. Any further questions from the committee? Well, hearing none, I want to thank the panel for taking the time to be here and for sharing information. We're going to take this back to Washington and as Mr. Feeney said, he already has legislation that he has filed. And there's a lot of interest growing to make needed reform. So thank you for being here today and this includes our Government Reform Committee hearing.

Ms. Kelly. Mr. Chairman, I would like to say I do thank the staff from Washington from this committee that came here and did all the work to set this up. They did an excellent job.

Mr. McHenry. Yes.

[Whereupon, the subcommittee was adjourned.]

[Additional information submitted for the hearing record follows:]

OXFORD ANALYTICA

ASSESSMENT OF THE ECONOMIC BENEFITS AND OPPORTUNITIES FOR A PAN-EUROPEAN GROWTH MARKET

A Study

Prepared for

The London Stock Exchange

Oxford Analytica Ltd
5 Alfred Street, Oxford OX1 4EH

EXECUTIVE SUMMARY

INTRODUCTION

Capital markets contribute to economic growth by providing liquidity, broadening the range of financing services beyond those available from banks, promoting the development of transparency, and catering to the needs of expanding companies. From the perspective of the increasing globalisation of financial markets, access to capital is fast becoming more important as a driver of growth than the physical location of a market.

SMEs are frequently held back by a lack of credit, a crucial factor given their importance in job creation and innovation. The development of high technology companies has been particularly constrained by the tendency of banks to favour low-risk projects. The underdeveloped equity culture has made it difficult for companies to 'graduate' from venture capital to a scale of operations that would make them internationally competitive.

The emergence of a pan-European SME equity market promises considerable benefits for the European economy -- the growth benefits of an effective pan-European platform can be estimated at up to 0.3-0.6% of the Union's GDP, or between 28.32 and 56.63 billion euros.

THE DEMAND FOR RISK CAPITAL ACROSS EUROPE

The EU economy is heavily dependent on the SME sector, which in turn has been largely reliant on debt financing. Despite pervasive pessimism about the listing potential of SMEs, historical precedents and international comparisons suggest promising prospects for this means of raising capital. Developments in eastern and northern Europe are especially favourable. Even more generally, a momentum generated by positive examples, pressures for generational change and better awareness of financing options may lead to IPOs on a scale comparable to the UK in the medium- to long-term.

Should AIM attract most of these companies, it has the potential of perhaps trebling in size the number of listings in the medium term; in some European countries, as many as 5% of medium-sized companies are seen as candidates for listing.

ASSESSING THE EUROPEAN CREDENTIALS OF AIM

London enjoys a number of key advantages as a financial centre, including its high liquidity, its ability to enhance the reputation of those companies which meet its requirements, the range of competitively priced auxiliary services it can offer, and the sheer convenience associated with access to one of the largest pools of investors in the world. AIM is able to benefit from these in attracting more European SMEs.

AIM also has a unique advantage in Europe due to its size, its longevity, the range of companies represented, and the flexibility of criteria designed to make admission possible for many types of companies, including new ones traditionally reliant on other sources of finance. In addition, its status as a global source of capital makes it not only easy, but also profitable for foreign companies to turn to AIM to raise capital that will then be employed in their domestic markets.

INTRODUCTION

In 1911, Joseph Schumpeter was among the first to argue that the services provided by the financial sector – mobilising savings, evaluating projects, managing risk, monitoring managers, and facilitating transactions – are essential for technological innovation and, consequently, economic growth. While no universal consensus exists on the exact nature, scale, and significance of the impact of capital markets on economic growth, the following findings are now broadly accepted:

- Over the long term, there appears to be a positive correlation between stock market development and growth with the creation of liquidity constituting the main driver. While there is no agreement on the size of the impact of stock markets on growth, estimates range from 0.5 to 1.0 percentage points of GDP. In contrast, the size and volatility of stock markets have been found to be less important. Liquid equity markets reduce risks by allowing investors to quickly dispose of their assets at will, instead of having to make a formal long-term commitment. Companies, however, can enjoy the prospect of secure financing once shares have been placed, irrespective of who owns them.

- Stock markets are a complement to banks; they can fill niches and provide services that banks cannot. Indeed, to the extent that stock markets can create a more competitive environment or offer financial services of a different kind than the banking system, they can provide an additional impetus to economic activity.

- The quality of the legal framework in which markets operate is critical and its contribution is apparently greater than that of the markets, or any market sector, per se. Even as comparisons of bank-based and market-based systems have revealed significant differences in incentives, the absolute quality of banks and securities markets in a given country depends on the ability of the legal system to enforce contracts. Importantly however, legal systems in a country may have comparative advantage in protecting one system over the other. Countries with legal codes offering rigorous protection of minority shareholders tend to have market-based financial systems. Moreover, there appears to be a positive link between common law legal systems and the relative dominance of capital markets over banks.

- The structure of financing is connected with the level of economic development in as much as firms tend to prefer equity capital as their overall capital levels increase. Thus countries would appear to become more market-based as they grow richer. Richer countries tend to have higher levels of stock market development relative to the development of their banking systems.

Significantly, however, from the perspective of the increasing globalisation of financial markets, access to capital is more important as a driver of growth than the physical location of a market. The United States is a key case in point, in as much as most trading is concentrated in two national stock exchanges. There is little reason to assume that a larger number of markets could increase the availability of capital in the US. Conversely, as institutional and regulatory harmonisation proceeds apace, the argument for over 30

different stock exchanges in Europe begins to look far less compelling in terms of the ability of markets to supply capital.

The advantages of globalisation are also important because the monitoring component of intermediated finance tends to be information-intensive, as the financial intermediary needs to have skills that enable it to evaluate the progress of the entrepreneur. In some cases, it may well be that these skills are not available locally or not comparable in terms of quality to those offered by large international centres.

SME Needs

Whatever the relative advantages of different elements of the financial sector on the macro level, there is considerable evidence to suggest that European small and medium-sized companies (SMEs) are frequently constrained by a lack of credit in their operations, although the lack of growth is also driven by a cultural aversion to debt in many countries. SMEs typically depend primarily on banks for their financing, even if access to financing tends to be driven by the structure of the financial system, as well as the culture and the traditions of a given country. Indeed, these factors appear consistently more important in determining financing decisions than the particular characteristics of a company, such as size, sector of operations, age, or even profitability.

The potential offered by equity financing is especially important given the nature of financing obtained by SMEs. By and large, they tend to rely disproportionately on short-term capital. Moreover, medium-sized companies in particular are in a very asymmetrical, and often disadvantageous, relationship with their banks. Some one-third of them work with only one bank. In general, they pay interest rates and bank charges that are higher than those charged to larger companies. Access to bank credit tends to be further complicated by higher collateral requirements. Leasing is frequently an alternative source of financing but tends to be more expensive than bank loans. In some cases, companies can obtain additional support from regional, national, or EU-wide support measures but more than 80% do not do so, admittedly in most cases by choice.

The European Observatory of SMEs regularly surveys SMEs in the EU in its ENSR Enterprise Surveys. The findings of recent years highlight the importance of credit constraints. According to the 2003 survey, approximately 13% of small enterprises (with less than 50 employees) feel that the availability of finance is the major constraint on their development. In contrast, 8% of medium-sized firms (50-249 employees) complained of insufficient finance. Loan applications from 7% of SMEs were declined, and 2% received only part of the loan they had requested. The importance of the finance bottleneck varies across countries. The percentage of SMEs constrained by access to finance was lowest in the Netherlands, Belgium, Finland, and Ireland (5-7%) and highest in Italy, the UK, Denmark, and Greece (17-22%). Beyond this, however, the finance constraint is felt with particular acuteness by innovative firms. 28% of medium-sized firms reported in May 2001 that a lack of finance was the most important obstacle to innovation. The corresponding figure for small enterprises was 24%.

The ENSR Enterprise Survey 2002 found two-thirds of SMEs were satisfied with the bank services they received. 20% were 'neutral' and 12% were 'dissatisfied'. This discontent is especially prevalent among medium-sized companies, which feel that banks are unable to adequately meet their financing needs. The main causes of dissatisfaction, cited by more than 20% of SMEs, were poor service, excessive bank charges, high interest rates, administrative requirements, and frequent changes of the contact person. In general terms, those neutral or dissatisfied companies would seem to constitute the most obvious source of demand for other kinds of financing. However, even some of those satisfied with the current level of service received might wish to seek additional funding, diversify their sources of financing, or consider

alternatives for new projects. Indeed, in many countries, the reliance on bank credit, as well as presumably the degree of satisfaction with it, is driven primarily by cultural factors.

The needs of SMEs for financing are often considerable. According to the findings of the ENSR Enterprise Survey 2003, some 60% of SMEs had bank liabilities of up to 100,000 euros. The liabilities of 16% varied between 100,000 and 500,000. 3% had bank liabilities of 500,000-1 million euro, while the liabilities of another 1% exceeded 1 million. Moreover, survey evidence suggests that one-third of SMEs have identified growth as a key priority.

In important ways, the development of bank finance has paved the way for other types of financing. This is particularly important with respect to transparency, which is frequently used as an argument against stock exchange listings. However, in actual fact, only 20% of SMEs do not provide any information at all to their banks. Some two-thirds supply balance-sheet statements and a significant number provide various kinds of additional information as well.

The economic implications of ensuring adequate financing for SMEs are of paramount importance. SMEs account for roughly two-thirds of the jobs and one-half of the turnover of European businesses outside the agricultural sector. Empirical evidence suggests that SMEs are, on average, just as innovative as large companies and, as demonstrated by the high technology sector in particular, can provide an important impetus to economic growth.

High Technology Growth Companies

The role of market-based financing seems especially valuable in industries characterised by a rapid pace of technological change and a lack of consensus on management strategies. Since some worthy projects require large capital injections and enjoy potentially significant economies of scale, stock markets that can ease resource mobilisation can boost economic efficiency and accelerate long-term growth. However, since banks make loans, they have an inherent bias towards low-risk -- and therefore low-return -- projects. Thus, a heavy reliance on banks as a source of capital may retard innovation and growth.

Survey evidence on the access of European high-technology companies to financing suggests limitations in this area are among the main reasons for Europe's inferior high-technology performance as compared to countries such as the United States. Attempts to address shortcomings in the 1990s, notably by Easdaq, eventually proved largely unsuccessful. There seems to have been three main reasons for this suboptimal outcome:

- The creation of Easdaq, in particular, triggered a nationalist response through the establishment of several new exchanges or boards on the national level. In particular, liquidity was spread over a number of exchanges. Largely as a result, the new markets were unable to develop a critical mass on their own.

- The dotcom crash undermined the new ventures at a critical point in their development. Again, the fragmentation meant a lack of liquidity and sustainability that made it impossible for most platforms to survive the crisis, given their dependence on listing and trading fees.

- The new markets turned out to be overly reliant on one economic sector and were ultimately undermined by significant changes in the conditions affecting that sector. This vulnerability was further amplified by frequently insufficient regulation of these markets.

Europe's weakness in high technology is further undermined because the available venture capital is spread too thinly across the sector. Although the total scale of venture capital investments in Europe tends to lag behind the US, the effects of the available resources are diluted further by the failure to concentrate them in a way that would allow a significant number of companies to enjoy adequate access to capital. For example in 2003, while total European venture capital investments reached 54.3% of the US level, the average investment was only 18.2% of the corresponding level in the US. Among other things, this excessive distribution reduces the chances of a given company being able to develop to a critical size to support an IPO.

The absence to date of a pan-European SME growth market has made it difficult for companies to 'graduate' from venture capital and reach a scale of operations that would make them internationally competitive. In addition, the absence of a market mechanism for valuing companies has weakened the position of European SMEs in the event of mergers and acquisitions. Lastly, the capital constraints have made it more difficult for European growth companies to offer competitive packages to their most talented employees. The SME sector continues to be plagued by a brain drain to the US.

The Potential Contribution of a Pan-European Growth/SME Platform

To the extent that the national bias of European exchanges can be overcome in order to allow a pan-European growth/SME platform to emerge, a number of network effects promise the prospect of a virtuous circle through economies of scale and reduced costs. Increasing liquidity will combine with a steady growth in the number of investment opportunities for investors. At the same time, the concentration of research and analysis means that fewer companies are likely to fall into an informational illiquidity trap.

Ultimately, the emergence of a dominant pan-European SME market promises considerable benefits for the growth of the European economy. While such benefits will be difficult to quantify, it is likely that a European-wide platform that is competitive in cost terms, liquidity, and accessibility will remove some important constraints facing growth companies at critical stages in their development. Among other things, such a platform can begin to overcome the advantage held by the US in new technology. One reputable estimate puts the contribution of IT alone to US economic growth at 0.74% in 1995-2000 (although some figures go as high as 1.86%). To the extent that improved access to capital can be used to unleash new productivity growth in Europe, especially in countries that are lagging behind, some of this gain should become more readily attainable. In addition, more plentiful and cheaper capital across the economy should help stimulate research and development -- a problem area in many countries and sectors, and one critically dependent on long-term funding. Finally, the traditional direct and indirect effects through employment and consumption can be considerable in some cases.

The key determinant of the size of the contribution to growth is the ability of a pan-European growth/SME platform to create value that otherwise would not have been created, or would have been created on a much smaller scale. Extrapolating from the above estimated links between stock markets and growth, as well as the degree of bank dominance of individual EU economies, the growth benefits of an effective pan-European platform can be roughly estimated at 0.3-0.6% of the Union's GDP, or between 28.32 and 56.63 billion euros.

THE DEMAND FOR RISK CAPITAL ACROSS EUROPE

This element of the study will estimate the demand for risk capital on the part of SMEs in continental European EU member states. It will provide estimates of the number and size of SMEs and seek to assess the potential they represent for new equity listings. SMEs are defined here according to the criteria set by the European Commission:

Enterprise category	Headcount	Turnover, euro	Total balance sheet, euro
Medium-sized	50-249	10-50 million	10-43 million
Small	10-49	2-10 million	2-10 million

The availability of data on European SMEs still tends to vary from country to country, although Eurostat now compiles Union-wide statistics. However, statistics on sales, turnover, etc., are still primarily a national responsibility that is typically assumed by different agencies in different countries. The comparability of the data across countries is thus affected by the availability of information, some methodological differences, discrepancies in classification, and exchange rate considerations. As a result, the data assembled in this section is indicative rather than precise.

Its limitations notwithstanding, the statistical data on European SMEs underscore the heavy dependence of the EU economy on the SME sector.

Country	Number of Companies			
	By Number of Employees		By Turnover, euros	
	10-49	50-249	2-10 million	10-50 million
Austria	29,800	4,600	20,000	5,000
Belgium	26,300	3,900	22,000	6,000
Czech Republic	48,800	11,300	7,200	2,400
Cyprus	2,500	430	640	100
Denmark	17,300	3,200	21,000	5,000
Estonia	6,200	1,200	3,500	150
Finland	13,200	2,300	8,000	2,000
France	100,000	19,000	70,300	18,700
Germany	308,200	66,200	124,000	29,000
Greece	16,100	2,200	10,000	2,000
Hungary	26,000	3,000	6,600	1,800
Italy	191,100	21,200	80,000	19,000
Latvia	6,500	1,800	2,500	400
Lithuania	11,000	2,400	4,000	700
Luxembourg	950	200	n/a	n/a
Netherlands	53,000	10,600	27,000	6,200
Poland	144,600	31,100	30,000	6,000

Portugal	34,200	5,200	20,000	4,000
Slovakia	10,500	3,000	3,000	800
Slovenia	5,100	1,200	1,600	400
Spain	150,000	22,000	90,000	14,000
Sweden	13,800	2,500	16,700	4,200
Total	**1,215,150**	**218,530**	**568,040**	**127,850**

N.B. Some of these figures are rough estimates based on incomplete data.

Source: Eurostat, National statistical agencies, associations of SMEs

SME Demand for Capital

European SMEs are historically heavily dependent on debt financing. A survey by the European Commission in 2001 found that 50% of European SMEs relied on overdrafts, 46% on bank loans, 39% on leasing, and 11% on factoring. In contrast, only 9% received equity from external investors, equal to the percentage of SMEs relying on subsidies. Bank loans were a particularly important source of funding in the bank-dominant economies of Central Europe, with Germany, France, and Austria, as well as Finland, all recording rates in excess of 60%. Even in the UK -- a classic case of market-based economy -- SMEs in 2000-02 received 52% of their external funding from banks.

Even though assessing the demand for risk capital by the SME sector is difficult, a number of considerations would suggest that the endemic pessimism about IPO prospects by European SMEs might be misplaced.

Historical precedents. Even though the dotcom bubble of the late 1990s is widely viewed as a failure, it indicated the preparedness of growth companies to seize opportunities available to them. Easdaq in September 2000 had 62 listed and 83 traded companies, a market capitalisation (of listed companies) of 53.7 billion euros, and an average daily turnover of 102.7 million euros. By the end of 2000, the member exchanges of EuroNM had a total of 567 listings that raised more than 40 billion euros. While the negative legacy of the dotcom bubble may not be easy to overcome, the potential for rapid expansion clearly exists.

Maturing Venture Capital Investments. Venture capital has become an important source of financing in Europe, even if the efficiency of its use is not yet comparable to the situation in the US. Total European venture capital investments in 2003 were estimated at 29.1 billion euros, followed by 36.9 billion in 2004, and were distributed over 10,236 projects (10,375 in 2003). Start-up investments rose from 2 to 2.2 billion euros over the same period. However, the availability of venture capital still varies a lot between countries.

- The UK accounted for 52% of the investments in terms of the country of management, followed by France (14%), and Germany (10%).
- In terms of the country of destination, however, the UK's share was 26%, followed by France (17%) and Germany (14%).

The total European venture capital portfolio was estimated at 156.1 billion euros at the end of 2004. Annual venture capital investments on the scale of 10 billion euros supported 34 IPOs in 2004 alone and

178 in 2000. Depending on the distribution of the funds, an extrapolation from that assumption suggests that the total of new investments in 2003-4 could provide the basis for well over 100 IPOs and possibly as many as 300. Divestments through IPOs and the sale of quoted equity have, in fact, been increasing at an accelerating pace. A 44% jump in 2004 took the total to 2.3 billion. Although IPOs grew by a remarkable 81%, they still accounted for only 7% of total divestments.

Ongoing Developments. AIM in particular has established itself as an effective mechanism for raising capital for SMEs. The amount of capital raised on AIM in 2004 was some 4.7 billion pounds. According to data compiled by PricewaterhouseCoopers, the 273 IPOs on AIM, compared to a European-wide total of 420, accounted for 12.95% of the total of 27.3 billion euros raised on European capital markets. Euronext was the most active IPO market in continental Europe in 2004. It had 48 IPOs worth 8.5 billion euros, of which Belgacom accounted for 3.3 billion. The Warsaw Stock Exchange had 36 IPOs worth 3 billion euros, of which PKO BP accounted for 1.8 billion. IPOs on all other European exchanges were in the single digits and dominated by large deals, such as T.E.R.N.A. in Italy and Deutsche Postbank in Germany.

Trans-Atlantic Comparisons. AIM specialises in raising capital for SMES. In spite of this fact, the US remains solidly ahead of Europe in terms of SME/growth company listings. Nasdaq has a total of some 3,200 listings and a total market capitalisation of some 3.1 trillion US dollars. By comparison, the estimated number of US SMEs is well over a million.[1] Nasdaq saw 55 new listings worth 4.8 billion euros in 2003 and 170 listings worth 15.8 billion in 2004. This compared to European totals of 6.8 and 27.3 billion euros in the same two years respectively, and offers some indication of the potential for growth in Europe, should a critical mass and proper equity culture be allowed to develop. Yet the gap is large. The average capitalisation of Nasdaq-listed companies is 1.159 billion US dollars, as compared to 51 million for AIM-listed companies. During the first half of 2005, the comparisons between the two markets were as follows, indicating at least a temporary closing of the transatlantic gap:

	Number of IPOs	Offering value, million euros
Europe total	267	16,921
AIM	152	2,550 (one dual listing)
Nasdaq	51	3,591

Source: PricewaterhouseCoopers

The prospects for European IPOs remain country- or region- specific. The British Isles, Scandinavia, and Eastern Europe would seem to offer the best prospects, whereas activity in the large economies such as France, Germany, and Italy is relatively depressed, partly due to the unfavourable macroeconomic climate and a lack of investor confidence. In addition, banks will remain a source of tough competition throughout the continent -- not least due to the historically low interest rates -- but especially in the leading central European economies which remain bank-centric and where banks actively court corporate clients. Similarly, there is a strong resistance, especially by family-owned companies, to surrendering complete control, as well as to higher transparency. However, in Germany a large number of third-generation *Mittelstand* companies have now reached a point where the families are ready to divest, and positive examples here might have a large impact.

[1] The following figures are the number of companies as classified by the number of employees. The average receipts for each category are provided in brackets in thousands of US dollars: 10-19 employees: 613,880 companies (1.77 million US dollars); 20-99 employees: 508,249 companies (5,68 million US dollars); 100-499 employees: 82,334 companies (30,94 million US dollars).

Interviews with market institutions and observers suggest that the prospects for IPOs in the countries with the most dynamic equity markets might lead as many as 5% of their medium-sized companies to list over a 5-10 year horizon. The best prospects at the moment are offered by the new EU members in Eastern Europe, and by the Scandinavian countries. In Poland, this might mean some hundreds of companies; with the Czech Republic and Hungary, perhaps up to a hundred in each. Scandinavia offers the potential prospect of several hundred listings. Especially in the German-speaking countries of central Europe, as well as France and Italy, progress is likely to be more gradual, and conditional on a positive momentum developing in response to new initiatives and an example set by a critical mass of companies. Even then, complete convergence with the market-dominated economies is unlikely. However, should an equity culture begin to take shape, IPOs on a scale comparable to the UK may be a medium- to long-term prospect. Indeed, Germany, France, Italy and Spain each have hundreds of companies of real investor interest. Should AIM attract most of these companies, it has the potential of perhaps trebling the number of listings in the medium term.

Even if the numbers of IPOs are large, the average AIM IPO in 2004 was calculated by PwC to be worth 12.95 million euros, clearly below the averages of 18 million in Stockholm and 34.4 million in Warsaw (even after the 1.8 billion PKO BP has been removed.) However, regardless of the initial IPO size, the most dynamic companies can potentially return to the market fairly frequently. AIM has seen a large number of examples of companies grow far beyond their initial size, something that lends support to the potential of stock markets to put companies on a fast-growth trajectory by removing finance constraints. The following are particularly salient examples from AIM:

Admission Date	Company	Sector	Country of Domicile	Current Market Capitalisation, million pounds	Market Capitalisation on Admission, million pounds	Growth since Admission, %
July 2004	Nelson Resources	Oil & Gas - Exploration & Production	Bermuda	1,043.69	474	120
June 2005	Empire Online	Media Agencies	British Virgin Islands	727.55	512	42
April 2001	First Quantum Minerals	Other Mineral Extractors & Mines	Canada	702.10	46	1,426
March 2003	Hardman Resources NL	Oil & Gas - Exploration & Production	Australia	644.28	95	578
November 2003	Yamana Gold Inc.	Gold Mining	Canada	275.60	141	95
December 2003	Oilexco Inc.	Oil & Gas - Exploration & Production	Canada	226.16	28	708
November 2004	Abbey	Other Construction	Republic of Ireland	211.79	189	12
October 2002	Celtic Resources Holdings	Gold Mining	Republic of Ireland	138.12	36	284

June 1999	CPL Resources	Education, Business Training & Employment Agencies	Republic of Ireland	55.93	18	211
May 2004	Teleunit SpA	Fixed-Line Telecommunication Services	Italy	41.00	37	11
December 2003	BKN International AG	Television, Radio and Filmed Entertainment	Germany	32.54	10	225
April 2003	Thirdforce	Education, Business Training & Employment Agencies	Republic of Ireland	23.50	13	81
September 2004	TV Loonland AG	Television, Radio and Filmed Entertainment	Germany	10.74	8	34

Source: LSE

The key challenge for AIM in maintaining its momentum is to expand beyond the extractive sector, which has offered some of the most spectacular successes to date.

Reasons for and against Stock Market Entry

The Grant Thornton European Business Survey 2002 provides valuable evidence on why European SMEs choose to list or not. The survey found that 47% of medium-sized companies expected to see a change in ownership. 11% of them thought that the change would take the form of a flotation, yielding the relatively high percentage of potential IPOs by medium-sized companies of 5.17%. The survey found that the main perceived obstacle to flotation by SMEs was the small size of the company, a cause cited by 46% of those interviewed. An almost comparable figure, 43%, felt that the stock market was not relevant to their business. Even if the data is not current and may have been skewed by the relative weakness of the EU economy at the time of the interviews, the findings are likely to reflect attitudes that change relatively slowly. Flotation is an important option for SMEs faced with a generational change among the controlling group, especially in family-owned companies.

Barriers to Stock Exchange Flotation

Reason*	**Percentage of Medium-Sized Companies**	**Percentage of All SMEs**
Company needs to be bigger	43	46
Not relevant to my business	37	43
Process too time-consuming	20	11
Entry criteria	14	11
Too expensive	14	9
Equity dilution	15	8
Market valuations too low	10	6
Lack of liquidity in the market	9	5
Vetting by stock exchange	4	2
Language difficulties	1	1
None	3	3

* Each respondent was asked to identify the three most important barriers.

Source: Grant Thornton European Business Survey 2002

There were considerable national differences among the respondents. For example, Polish SMEs focussed particularly heavily on the expensive entry criteria, something that the Polish markets and authorities have subsequently addressed with some success. More generally some of these concerns can be alleviated through regulatory reform, better information dissemination, and investor/issuer education. Together such factors may begin to develop a European equity culture and create a virtuous circle for equity market growth.

The survey also asked companies about the perceived benefits of listing on a stock exchange and found the following results:

Benefits of Stock Exchange Flotation

Reason*	**Percentage of Medium-Sized Companies**	**Percentage of All SMEs**
Availability of capital	40	28
Ability make acquisitions by acquiring shares	24	14
Profile raising	20	15
Exit opportunity	12	8
Cost of capital	10	6
Ability to grant options to employees	8	7
No security required	3	3
None	11	13

* Each respondent was asked to identify the two most important barriers.
Source: Grant Thornton European Business Survey 2002

One important factor working in favour of more listings by SMEs is the increased use of credit scoring under Basel II which, it is widely felt, may reduce the availability of bank finance to SMEs. The ongoing consolidation of the banking sector is likely to have a similar impact. This is important, in as much as empirical evidence suggests that the typically higher interest rates paid by SMEs are not justifiable on credit risk grounds alone. Rather, banks may be able to overcharge due to limited competition at the local level, with the effect of locking companies into long-term relationships. At the same time, the increased information supplied to banks can be used to seek other types of financing solutions as well.

ASSESSING THE EUROPEAN CREDENTIALS OF AIM

The increasingly integrated capital markets of Europe offer companies across the continent new opportunities to benefit from the advantages offered by major financial centres. The EU Financial Services Action Plan has done a great deal to harmonise the regulatory framework governing securities markets across Europe and to eliminate many of the institutional barriers between jurisdictions. At the same time, the single market in general has contributed to a high degree of economic integration across the continent, which manifests itself, among other things, in the dominance of intra-EU trade and the growing pan-continental profile of EU companies.

London is especially well positioned to capitalise on these regulatory developments. Its main advantages comprise of its historic strength and global role in the financial sector, and the significant limited availability of new capital to companies in the EU, most notably in the financial services sector. More specifically, London's principal competitive advantages include:

- **Liquidity.** London is a global market place that brings together unparalleled numbers of investors. In 2004, London accounted for 39% of total equity trading and over a quarter of the total capitalisation of exchanges in Europe. It is at the forefront of financial innovation and new opportunities are typically identified quickly and exploited effectively. Largely as a result, London can offer issuers strength of demand that they are unlikely to find in smaller markets. It is the most liquid market in Europe with a turnover-to-GDP ratio of 173.16% in 2004, which compared to 119.06% in Sweden, but only 65.50% in France, 51.80% in Germany, and 48.10% in Italy.

- **Reputation Building.** Listing in a major international market gives companies the positive side benefit of name recognition far beyond their national boundaries. At the same time, they can build their transparency based on requirements that are well known to most investors and recognised by them as adequate. Among other things, this type of "endorsement" of a company can help improve access to other sources of capital. For example, evidence suggests that listed companies find it easier to borrow money.

- **Financial services infrastructure.** London has one of the most advanced service sectors in the world. Thus services associated with listing, reporting, auditing, legal requirements, analysts, etc., are easily available from a number of alternative suppliers. All of them operate in a competitive environment that can ensure more competitive pricing than the services available in smaller markets. The attention devoted to companies by the large research and analyst community is especially important in raising their profile and liquidity.

- **Economies of scale.** The large size of the London market implies economies of scale and positive networking effects while reducing the role of fixed costs. Thus the prices charged by stock exchanges and clearing houses can be lower than elsewhere, especially in smaller markets. This advantage is especially important since costs of cross-border clearing and settlement remain high, which is an argument for listing companies close to their investor base.

- **Regulation and Enforcement.** The age, maturity, and importance of the London financial markets means that its regulatory framework has had an opportunity to evolve over time to best reflect the needs of the market; many smaller and younger markets have not had this opportunity.

- **Convenience.** Although the harmonisation of securities market legislation in the EU has been designed to reduce barriers between national markets, one of London's attractions will continue to be (even if harmonisation should advance further) the sheer convenience of providing immediate access to one of the largest pools of investors and financial services in the world. Thus, through a listing in London, barriers will be eliminated, rather than merely reduced. This has been one of the factors prompting many foreign companies to opt for a dual listing in London.

In building further on its role as an international source of capital, AIM will be able to benefit from the strong and long-standing European credentials of the London Stock Exchange. In spite of its strong national profile, LSE is effectively an international bourse with a strong European presence which looks set to grow further in the coming years. Its European credentials cut across all key aspects of the securities business:

- **Issuers.** As of August 2005, 64 continental European (EU) companies were listed on the London Stock Exchange, a figure that compares to a total of 337 overseas listings. Their total market capitalisation of 501,048.21 million pounds accounted for just under a quarter (24.09%) of the total for overseas companies. Although in many instances, especially historically, larger companies opted for a dual listing, there are a number of foreign companies listed exclusively in London. Also, AIM, which accounted for 65% of European IPOs in 2004 (up from 55% in 2003), is beginning to attract more continental European listings.

- **Investors.** London's status means that all the world's leading investment banks and a large number of other entities are represented there. Indeed, the size, reputation, and liquidity of the London market make an attractive destination for institutional investors who might be barred from smaller, less liquid shares through regulation. AIM is a direct beneficiary of this state of affairs in as much as institutional investors now hold 41% of the shares trade on AIM – a combined value of 19.3 billion pounds, up from 9.75 billion a year ago and 4.5 billion in 2003.

- **Advisors.** The size of the London market means that investment banks from across Europe have an interest in it. For example, the Nomads at AIM include most of the leading banks from continental Europe.

In addition to its European credentials, London serves as a source of financing for UK, Irish, and non-EU-domiciled companies with extensive European operations. The economic integration of the continent under the auspices of the single market means that a large, and growing, number of companies now operate with a pan-European profile regardless of where they raise their funds. For example, 1-13% of SMEs in the various EU member states had subsidiary branches or joint ventures abroad in 2001. In the cases of German, Dutch, and Hungarian medium-sized companies, the figure was as high as 16-17%. Over 60% of medium-sized and over 40% of small European industrial companies are engaged in export. The figures in trade and services vary from 20% to just over 40%. Overall, some 60% of small and 63% of medium-sized companies are internationalised in one way or another.

The growing role of the London Stock Exchange as a truly pan-European platform is also likely to bring indirect benefits by forcing other European exchanges to compete by seeking to lower costs, streamline

regulation, and target sectors and companies that previously might not have been considered candidates for stock exchange listing. Ideally this process could represent an important step towards developing a genuine equity culture across the continent. Such indirect efforts may well have a key role to play for some time. Many companies with a local profile are reluctant to list abroad, largely for fear of losing their domestic investors who know them. However, dual listings constitute a potential intermediate step, especially after the limits of the home market have been reached. Again, the performance of dual listed companies can inspire others to follow.

AIM Potential

AIM has during its decade-long existence established itself as the most successful SME-focussed new market of Europe. While other markets or market segments on the continent cater to SMEs and high-tech companies, AIM's position is unique in a number of ways.

Size. In August 2005, AIM had 1,292 quoted companies with a total capitalisation of 70.42 billion euros.[2] The number of companies has more than doubled since September 2003. In contrast, the total capitalisation of AIM-listed companies has more than trebled over the same period. By comparison, there were a total of 113 listings with a combined total of 34.49 million euros on the six other new markets of Europe.[3]

Longevity. Following the absorption of the Nouveau Marché into Euronext in 2004, AIM is the only SME growth market in Europe to have weathered the storm of the market downturn at the beginning of this decade. Among other things, this development would seem to underscore the advantages of size, liquidity, and reputation, and to constitute an argument for further developing AIM's credentials as a pan-European market. Moreover, AIM's longevity and size have enabled it to establish a brand name unrivalled by other markets. Reaching this point has taken years and the success would be difficult for another institution to replicate.

Scope. Unlike the growth exchanges of the 1990s and some of the current new markets, AIM has not focussed narrowly on IT or high-technology companies, a dependency that proved fatal for Easdaq and its continental European rivals. Rather, equity funding is in principle available to companies across the board, something that both reduces AIM's vulnerability to sector-specific cyclicalities and increases its positive growth effects.

Flexibility. AIM is structurally well positioned to assume the role of a European growth capital market. In particular, it is notable that AIM has adopted Exchange regulated status, although its rules are modelled on the EU's Prospectus Directive. The regulatory role of the London Stock Exchange allows it to combine the reputation and standards of a major international market with the flexibility offered by a less extensive and demanding regulatory framework. AIM sets no formal admission criteria with respect to factors such as company size, track record, or free float. In order to verify and ensure the preparedness of companies for admission, they have to appoint a 'Nomad,' a nominated advisor from a pre-approved register. The key responsibility of the Nomad is to ensure that the company they introduce to the market is viable. Unlike the traditional responsibilities of an underwriter, the relationship between a Nomad and

[2] AIM figures. Exchange rate is the pound sterling – euro interbank rate as of 31st August, 2005.
[3] New Market (NE.HA.) of the Athens Exchange, Nuovo Mercato of the Borsa Italiana, IEX of the Irish Stock Exchange, NM List HSE of OMX Exchanges, Nuevo Mercad of the Spanish Exchanges, and SiTech of the Warsaw Stock Exchange. The Bratislava Stock Exchange has no listings on its new market. This uses the FTSE classification of new markets.

the company has the advantage of continuing past the listing itself. In addition, the Nomad system is recognised as a very effective way of bringing new companies to the attention of the investor community.

The low formal thresholds facing companies in terms of their size and past history mean that AIM has the potential to attract companies not only from the mature economies of Western Europe but also from transition economies, both in Europe and beyond. The credibility of the Nomad mechanism and the entities serving as Nomads means that there is a quality guarantee mechanism even beyond the formal listing requirements. In addition, the flexible regulatory framework promises to overcome one of the weaknesses of Easdaq, namely the high perceived costs of listing, even if the regulations for listed companies once they were on the market were considered very reasonable. The absence of "red tape" and lighter periodic disclosure requirements is recognised or acknowledged by many of the interviewees as a key determinant of AIM's accessibility to new groups of SMEs.

International character. In the increasingly integrated financial markets of the early 21st century, the link between the domicile of a company and its sources of funds is becoming less and less direct. Even if many of the companies interviewed in connection with this project emphasised the importance of the link between AIM quotation and their activities in the UK, the dismantling of economic barriers could eventually lead to a situation where a Bulgarian company raising money on AIM will be little different from a Texan company doing so on NASDAQ.

Ultimately, the experiences of several overseas issuers suggest that listings on AIM yield their primary benefits outside of the UK through value and job creation in the home markets of such companies. To the extent that raising finance on AIM is easier and cheaper than elsewhere, the home countries of the issuers can benefit from an improved ratio between the capital raised for domestic investment and its costs. Israeli IT companies are widely seen as examples of firms that have managed to overcome the limitations of the domestic capital market by raising capital overseas, while using the funds effectively to generate employment and growth at home. Twelve Israeli IT companies with market capitalisation of 273.49 million pounds are quoted on AIM; eight of them, which have joined since January 2005, have raised 59.5 million pounds. There are indications that AIM's attractiveness as a global source of capital has been further boosted by the relative regulatory disadvantage placed on US-listed companies by the Sarbanes-Oxley Act.

The globalisation of market participants and the companies providing support services further promises to reduce one of the hurdles faced by Easdaq and other technology exchanges in the late 1990s, namely the bias of underwriters in favour of their local exchanges which they knew best and which offered the smallest perceived risks. Whereas ventures such as Easdaq suffered from a lack of institutional investors to support their operations, in the rapidly consolidating and globalising marketplace of today, London can offer unparalleled access to investors, since the vast majority of them have a presence there. Indeed, the still-prevalent home bias of issuers has led to a situation where the distribution of small-capital stock across European exchanges has resulted in illiquid markets, insufficient research, and poor valuations.

One of the key challenges for AIM will be to further its European profile in a way that will enhance its local credentials outside of the UK. The Dutch Trading Service of the London Stock Exchange offers a model. Ultimately, working towards the status of a pan-European equity platform will require new initiatives to address the concerns of investors and issuers wedded to their national markets.

Comments by Market Participants and Observers

'AIM has been a success and has received international attention...and international companies have flocked to it', Dutch financial journalist.

'A mass of smaller companies are also listing on AIM and...it is becoming pretty fashionable with foreign companies', a UK equity trader.

'It is the most highly talked about market', Chairman of Corporate Broking at a major international investment bank.

'German SMEs lack equity capital; SMEs tend to use debt financing, and a few high net worth individuals', member of business development at a European equity specialist.

'After a [European company] listed last week, I have had many emails from the management of SMEs interested in listing on AIM', managing director from an AIM nomad.

'[Other European SME indices] lack the development/base and the liquidity [of AIM]', head of SME unit at a leading UK trade body.

'AIM...will take over...SMEs will look at AIM as the main market', CFO at a UK biotech company.

'AIM's advantage is its lighter regulatory touch', PR executive.

'AIM's advantage is that it has less regulation, less documentation', Corporate Finance analyst, leading investment bank.

'The attraction of AIM is that it has been around for a while and for smaller companies looking to list it is the number one place. European markets would have to build up their names before the same culture would develop. There is not necessarily a mistrust in Europe of listing, especially after Neuer Markt – that was really just the end of the internet bubble', Chairman of Corporate Broking at a major international investment bank.

'[AIM] fills a gap in market – the NASDAQ has more regulation and, if a small company, will get less coverage', CIO of a hedge fund.

'The real advantage of AIM is the infrastructure to support the market. There is a well developed set up of brokers and researchers who are used to putting companies in front of investors- this routine is lacking elsewhere', Fund Manager at a major European bank.

'The key to success is the investment story and the ability to communicate it. A major advantage of AIM is that the stock will be researched by analysts which would not happen here', CEO of a German company.

Source: Oxford Analytica Interviews

Canadian AIM Companies **28 April 2006**

List Date	Company	Sub Sector	Country of Origin	Mkt Cap £m
9/25/2003	ADASTRA MINERALS INC	General Mining	Canada	136.23
7/30/2003	ANTRIM ENERGY INC	Exploration & Production	Canada	47.87
8/12/2004	AZURE DYNAMICS CORP	Auto Parts	Canada	92.07
7/7/2005	BANKERS PETROLEUM	Exploration & Production	Canada	214.72
9/30/2003	BEMA GOLD CORP	Gold Mining	Canada	1,429.81
12/8/2003	BRAZILIAN DIAMONDS LTD	Diamonds & Gemstones	Canada	24.06
6/27/2005	CALEDONIA MINING CORP	Platinum & Precious Metals	Canada	41.51
6/22/2005	CANACCORD CAPITAL INC	Investment Services	Canada	533.11
9/21/2004	CASPIAN ENERGY INC	Exploration & Production	Canada	148.44
6/12/2003	CENTURION ENERGY INTERNATIONAL INC	Exploration & Production	Canada	570.97
8/26/2005	EASTERN PLATINUM LTD	Platinum & Precious Metals	Canada	0.00
11/30/2004	EUROPEAN GOLDFIELDS	Gold Mining	Canada	231.13
2/16/2006	EXCAPSA SOFTWARE INC	Gambling	Canada	219.08
7/30/2002	FIRST CALGARY PETROLEUMS	Exploration & Production	Canada	1,069.93
4/9/2001	FIRST QUANTUM MINERALS	Nonferrous Metals	Canada	1,543.98
3/10/2006	FUN TECHNOLOGIES INC	Gambling	Canada	211.71
3/31/2006	GALANTAS GOLD CORP	Gold Mining	Canada	16.18
8/4/2004	GREYSTAR RESOURCES	General Mining	Canada	118.63
12/2/2004	GROVE ENERGY	Exploration & Production	Canada	57.39
7/14/2004	HARD ASSETS INC	Specialty Finance	Canada	0.00
7/1/2004	KIRKLAND LAKE GOLD INC	Gold Mining	Canada	181.68
9/18/1998	MANO RIVER RESOURCES INC	General Mining	Canada	29.02
4/27/2005	MARCH NETWORKS CORP	Electronic Equipment	Canada	199.67
3/2/2004	MEDORO RESOURCES	Gold Mining	Canada	23.49
3/24/2006	MOTO GOLDMINES LTD	Gold Mining	Canada	192.74
9/30/2005	MOYDOW MINES INTERNATIONAL INC	Gold Mining	Canada	5.05
12/23/2003	OILEXCO INC	Exploration & Production	Canada	363.70
8/6/2004	ONDINE BIOPHARMA CORP	Biotechnology	Canada	41.30
2/16/2006	QUEST CAPITAL CORP	Specialty Finance	Canada	189.33
12/21/2004	QUESTAIR TECHNOLOGIES INC	Industrial Machinery	Canada	32.42
7/28/2005	SANATANA DIAMONDS INC	Diamonds & Gemstones	Canada	26.72
3/21/2006	SANDVINE CORP	Telecommunications Equipment	Canada	131.58
12/2/2004	SOLANA RESOURCES	Exploration & Production	Canada	88.41
8/13/2002	SOUTHERNERA DIAMONDS INC	Diamonds & Gemstones	Canada	40.91
8/14/2002	THISTLE MINING INC	Gold Mining	Canada	5.77
12/15/2004	URUGUAY MINERAL EXPLORATION	Diamonds & Gemstones	Canada	118.39
5/6/2005	VISUAL DEFENCE INC	Business Support Services	Canada	19.73
10/7/2004	WESTERN CANADIAN COAL CORP	General Mining	Canada	112.24
11/28/2003	YAMANA GOLD INC	Gold Mining	Canada	1,314.41
6/12/2002	YM BIOSCIENCES INC	Biotechnology	Canada	149.36
Total				9,972.74

Australian AIM Companies **28 April 2006**

List Date	Company	Sub Sector	Mkt Cap £m
3/21/2005	AIM RESOURCES	General Mining	30.95
11/16/2005	ANZON ENERGY	Integrated Oil & Gas	82.03
3/31/2004	AZTEC RESOURCES LIMITED	General Mining	65.97
12/2/2004	BALLARAT GOLDFIELDS NL	Gold Mining	213.87
3/17/2006	BETCORP	Gambling	50.92
4/20/2006	CAP-XX	Electronic Equipment	46.38
3/31/2005	CARPATHIAN RESOURCES	Exploration & Production	5.38
12/21/2001	CENTAMIN EGYPT	Gold Mining	166.84
3/2/2006	CERAMIC FUEL CELLS	Electrical Components & Equipment	87.54
4/14/2003	CONSOLIDATED MINERALS	General Mining	242.39
1/12/2005	DROMANA ESTATE	Distillers & Vintners	1.52
12/7/2001	DWYKA DIAMONDS	Diamonds & Gemstones	29.36
5/16/2005	ELIXIR PETROLEUM LIMITED	Exploration & Production	11.63
9/3/2004	ELKEDRA DIAMONDS	General Mining	24.84
1/4/2006	E-PAY ASIA	Internet	31.95
10/31/2005	ESERVGLOBAL	Software	59.41
7/20/2004	EUROGOLD	Gold Mining	10.84
3/22/2006	FINDERS RESOURCES	General Mining	13.89
3/9/2004	GIPPSLAND	General Mining	13.82
3/17/2005	GLADSTONE PACIFIC NICKEL	General Mining	40.71
3/7/2005	GLOBAL PETROLEUM	Exploration & Production	43.61
4/8/2005	GRAVITY DIAMONDS	Diamonds & Gemstones	17.27
12/16/2005	GVM METALS	Gold Mining	6.73
3/19/2002	HARDMAN RESOURCES NL	Exploration & Production	651.90
9/30/2005	INTERNATIONAL FERRO METALS	Steel	155.91
10/26/2005	LEYSHON RESOURCES	Gold Mining	20.71
5/5/2005	MAGNESIUM INTERNATIONAL	General Mining	10.08
7/3/2000	MURCHISON UNITED NL	General Mining	9.89
6/30/2004	NORWOOD IMMUNOLOGY	Biotechnology	47.71
6/10/2005	NOVERA ENERGY	Electricity	37.26
2/16/2006	OILEX NL	Exploration & Production	20.01
6/29/2004	PALANDRI	Distillers & Vintners	4.20
7/29/2004	PHOSPHAGENICS	Pharmaceuticals	56.04
11/30/2005	PLATINUM AUSTRALIA LTD	Platinum & Precious Metals	53.48
11/16/2005	PREMIER BIONICS	Medical Equipment	6.30
3/24/2005	PROCARBON	Specialty Finance	0.00
12/10/1997	RAZORBACK VEHICLES CORP	Auto Parts	1.19
9/6/2004	ROC OIL CO LTD	Exploration & Production	297.22
12/30/2005	RUSINA MINING	General Mining	8.58
12/1/2005	SEEING MACHINES	Computer Hardware	10.23
10/14/2005	UNION RESOURCES	Gold Mining	25.25
7/18/2001	VIROTEC INTERNATIONAL	Specialty Chemicals	39.87
			2,753.67

American AIM Companies **28 April 2006**

List Date	Company	Sub Sector	Mkt Cap £m
12/23/2004	121MEDIA INC	Media Agencies	29.06
5/22/2002	AKERS BIOSCIENCES INC	Medical Supplies	40.46
12/30/2005	ALLIED HEALTHCARE INTERNATIONAL INC	Health Care Providers	124.47
3/20/2006	AQUA BOUNTY TECHNOLOGIES INC	Biotechnology	73.44
2/6/2006	BODISEN BIOTECH INC	Specialty Chemicals	162.89
4/21/2006	BURST MEDIA CORP	Media Agencies	72.56
12/14/2005	CARDIOMAG IMAGING INC	Medical Equipment	23.78
12/28/2001	CLEAN DIESEL TECHNOLOGIES INC	Auto Parts	21.42
4/28/2006	CROSS SHORE ACQUISITION CORP	Specialty Finance	80.49
7/12/2005	CYBERSCAN TECHNOLOGY INC	Software	56.80
10/14/2005	DIC ENTERTAINMENT HLDGS INC	Broadcasting & Entertainment	111.51
4/16/2004	ELCOM INTERNATIONAL	Software	17.56
7/26/2005	ENOVA SYSTEMS INC	Auto Parts	49.61
4/12/2006	ENTELOS INC	Biotechnology	47.08
3/14/2005	FRONTERA RESOURCES CORP	Exploration & Production	78.08
9/2/2004	FRONTIER MINING	General Mining	38.29
12/6/2004	GATEKEEPER SYSTEMS INC	Business Support Services	20.62
10/3/2005	INTERNATIONAL METAL ENTERPRISES INC	Specialty Finance	145.26
1/6/2004	INVU INC	Software	25.52
3/16/2006	LEGACY DISTRIBUTION GROUP INC	Tobacco	9.73
10/31/2003	OCEAN POWER TECHNOLOGIES	Electrical Components & Equipment	50.73
3/30/2006	PEACH HLDGS INC	Specialty Finance	346.20
3/20/2006	PLANET GROUP INC	Investment Services	31.83
7/5/2005	POLYFUEL INC	Electrical Components & Equipment	61.15
3/29/2004	SKY CAPITAL ENTERPRISES	Business Support Services	32.63
7/15/2002	SKY CAPITAL HLDGS	Investment Services	11.72
5/12/2004	SOLAR INTEGRATED TECHNOLOGIES INC	Electrical Components & Equipment	114.74
10/31/2005	SPACELABS HEALTHCARE INC	Medical Equipment	91.94
6/22/2005	SPEARHEAD	Computer Services	5.28
4/11/2005	UTEK CORP	Specialty Finance	72.05
7/30/1996	WEST 175 MEDIA GROUP INC	Broadcasting & Entertainment	4.01
10/12/2004	XL TECHGROUP INC	Biotechnology	160.26
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